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AMERICAN PUBLIC FINANCE

BY

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TO
THE HONORABLE
MARK GRAVES

Preface

THE shift of American economy from a peace basis to a war basis has changed many elements in the fiscal picture. Not that there is one Public Finance for peace times and a different Public Finance for war periods. But certain spheres of fiscal theory that are relatively unimportant in times of peace assume outstanding importance when the nation is operating upon a war economy. Furthermore, the tremendous armament expenditures associated with war compel an expansion of federal taxation and borrowing that introduces new administrative problems.

In revising *American Public Finance* to include the new developments of war finance, I have employed the opportunity to bring all factual data up to date, and to rewrite freely wherever improvement might result. As in the earlier editions of this work, the primary objective is effectiveness as a textbook for undergraduate and graduate courses in Public Finance. In this connection, I have gladly employed many of the helpful suggestions made by users of the earlier editions who generously corresponded with me and gave me much constructive criticism. Chapter divisions have been made with a view to weekly assignments for either a one- or two-semester course during the average fifteen- or sixteen-week college semester. Chapter topics have been organized by sections and subsections to give students a clearer structural framework for their understanding of the subject. Much of the factual detail presented in the earlier editions is here omitted, since students interested in such detail can now be referred to the Tax Research Foundation's excellent biennial *Tax Systems of the World*. The appendix of administrative and tax report forms, first included experimentally in the preceding edition to afford students opportunity to observe the actual application of many of the principles discussed in the text, has been

a definite teaching aid, according to many instructors, and is retained in the present edition.

My indebtedness to the many friends who have afforded me help and encouragement in the original writing of this book and in the preparation of this edition must be covered by a blanket acknowledgment of gratitude. Charts were drawn by Miss Dorothy Moskowitz and Miss Ruth Knapier. Miss Helen Viggiani was my general manuscript and publication assistant.

W. J. S.

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Introduction

"PUBLIC FINANCE" is a loose term. "Public" as an adjective may describe not only the activities of a government, but those of a utility or a charitable association. "Finance" covers all forms and categories of monetary transactions—of individuals, of banks, of business corporations, and of governmental units. In combination, the terms "public" and "finance" do not, by themselves, describe any particular field of knowledge or study. But a century of popular usage in England and the United States has given "Public Finance" a precise connotation. "Public Finance" is the study of the facts, the principles, and the techniques of obtaining and expending funds by governmental bodies.

The subject matter of Public Finance has not been strictly delimited. Occasionally, individual scholars arbitrarily annex special topics to the general body of fiscal¹ thought. Quite often, they just as arbitrarily exclude some topic previously an integral element of fiscal knowledge. In this respect, Public Finance resembles other living and growing bodies of human knowledge; only narrow scholarship would demand rigid boundaries for its subject matter.

Three basic divisions in the subject matter of Public Finance are generally recognized: (1) the study of governmental² functions and expenditures, (2) the study of governmental borrowing and indebtedness, and (3) the study of current sources of governmental revenue, of which the most important is taxation. Those writers who isolate the technical aspects of raising and spending governmental

¹ "Fiscal" is the adjective corresponding to the noun-term "Public Finance." It covers the expenditure of governmental funds as well as the obtaining of such funds.

² Note that throughout this volume "governmental" is used in preference to "public" as an adjective applied to the activities of governments, whether federal, state, or local. The author would prefer the term "Governmental Finance" to "Public Finance" but defers to general usage in this matter.

funds, add a fourth general subject—"fiscal administration." In our analysis, administrative techniques associated with public expenditure are discussed under that heading, and tax administration is handled as a subdivision of taxation. Interrelations of federal, state, and local finances, of special importance in the United States, are brought together in a final section.

PUBLIC FINANCE AS A STUDY

Public Finance, we have said, surveys the principles and the techniques of certain governmental activities. As a study of principles, of cause-and-effect relationships, Public Finance must be considered a social science. As an exposition of techniques, of practical methods of raising and spending governmental funds, it is a political art.

Public Finance and related studies

Public Finance has developed few of its own principles. Instead, it has borrowed heavily from older, pre-established social sciences. Economics contributed first premises in the study of the shifting and the effects of taxes, and the effects of governmental expenditures and borrowings. Social Psychology and Sociology provided the derivation of some principles of tax administration. From the science of Government, Public Finance has accepted many generalizations; the analysis of governmental functions in Chapter I of this study, the subsequent discussion of expenditure and debt control, and the ultimate exposition of the interrelation of federal, state, and local financial functions—all are derived from the science of Government. Finally, History supplies evidence to support or contradict the various propositions which come under the purview of Public Finance.

Even as a political art—as an exposition of fiscal technique and procedure, Public Finance is not independent of allied fields of study. Since the powers of governments to spend, borrow, and tax are limited by constitutional and statutory restrictions, principles of law, and particularly of constitutional law, are an important background element for the study of Public Finance. Some understanding of accounting procedure and practice is essential to the study of

governmental units as going business concerns, and to the appreciation of the virtues and disadvantages of taxes levied upon various aspects of business activity.

Clearly Public Finance is not a single, compact, self-sufficient branch of human knowledge. Rather, it is a synthetic subject, pieced together from several allied sciences and arts. It achieves such self-unity as it possesses through the homogeneity of its subject matter—the monetary aspects of the activities of governmental bodies.

Public Finance is commonly studied as a branch of Economics, but this circumstance is more an accident of tradition than a reasoned conclusion. The Physiocrats, Adam Smith, and the English economists of the early nineteenth century were active critics of Mercantilism, a doctrine of governmental supervision and regulation. In their inquiries into the virtues and vices of various governmental activities, they searchingly considered the fiscal aspects of governmental activity in general. So far-reaching was their influence that later students viewed Public Finance as an integral element of Economics. Conceivably, had the problems of Public Finance a century ago been considered by students of governmental organization instead of Economics, Public Finance today might be studied as a branch of Political Science. That Public Finance is commonly classified as a subdivision of Economics must not blind students to the important elements of Government, of Law, of Sociology, and of other sciences and arts embodied in it.

Methodology of Public Finance

Public Finance has been described as both a political art and a social science. As a political art, it is an exposition of a technique. It presents a series of judgments, conclusions, and maxims on particular issues of practice and procedure, which may be taken as a guide and standard by legislators, administrative officials, and students of public affairs. Budgetary procedures and other expenditure controls are recommended. Debt management is analyzed. Techniques of tax administration are submitted.

These judgments, conclusions, and maxims—this fiscal art or tech-

nique—are not arbitrary, *a priori* propositions. They have evolved from scientific inquiry into the problems of governmental income and expenditure. Only after extensive comparative research, for example, was it possible to conclude that state assessment of extensive public utility properties is preferable to local assessment.³

A political art, technique, or procedure is lifeless. Judgments, conclusions, and maxims, of themselves, give birth to no new wisdom. They remain as they were formulated. Were society non-progressive, a fixed fiscal technique or procedure might be continuously effective and valuable. But, where changes are rapid, as in the Western World in recent times, a fixed technique or procedure is soon outmoded and valueless. With the development of state aid,⁴ of serial bonds,⁵ of gasoline taxes,⁶ within recent years, new procedures and critiques had to be formulated. If the judgments, conclusions, and maxims which constitute the art of Public Finance are to remain pertinent to actual governmental needs and circumstances, they must be ceaselessly expanded, modified, and supplemented by scientific inquiry. Students of Public Finance must be alert to pursue their inquiries into new subjects and new phases of familiar subjects. There can be no resting content with the fiscal technique previously acquired.

What is the methodology of Public Finance as a science? Nineteenth-century writers on Public Finance debated the respective merits of the deductive or the inductive method of inquiry. But this controversy has subsided, and its echoes are silent. In the science of Public Finance, as in most other fields of knowledge, deduction and induction are complementary tools of inquiry.

Inductive fiscal inquiry may be descriptive, historical, or statistical.

Until recent years, description—the case-study approach—has been the primary inductive tool of Public Finance, as of most social sciences. In the United States, at least, comprehensive information, or even data sufficient to permit application of the sampling techniques, was lacking for most fiscal topics. Students of Public Fi-

³ See pp 388 ff of this volume.

⁴ See pp 733 ff of this volume.

⁵ See pp. 678 ff of this volume.

⁶ See pp. 581 ff. of this volume.

nance were limited to detailed examination of the few individual cases where facts could be had. Such a case analysis of fiscal activity in Wisconsin or Boston might be used to support some general proposition of Public Finance—but there could be no assurance that Wisconsin or Boston provided a typical instance. As ever more individual case studies have become available, however, limited generalizations and working hypotheses, expressed in terms of possibility and occasionally probability, have been formulated.

Within recent years, statistical data on many phases of Public Finance have accumulated rapidly. Federal, state, and local bureaus, and various research agencies, now publish voluminous figures on governmental activities. All the variations of statistical procedure are available for the marshaling and use of these figures to discover pertinent generalizations for Public Finance. Statistical data are so complete that definite and final conclusions can be formulated in many instances. The tabulation of state and local tax revenues, for example, conclusively establishes the growth in the relative importance of the gasoline tax and motor vehicle license charge.⁷ In other cases, the conclusion derived from a statistical calculation cannot be stated as absolute, but it may be put forward tentatively as a probability or as an indication of a trend. Thus it may be stated that in normal circumstances it is improbable that business corporations can shift the federal corporation income tax.⁸ The value of the complete and tentative generalizations contributed by statistical inquiry to the science of Public Finance during recent years cannot be overestimated.

Descriptive and statistical analysis of current fiscal problems can be supplemented, within limits, by historical research. Every appropriation bill, every tax or governmental loan statute passed by legislative bodies, is in the nature of an experiment. Its results, favorable or unfavorable, appear in the course of time, and are noted in official or unofficial studies and reports. This record of past experiences is comparable to a series of experiments, with continual variation in controlling factors; as the series grows fuller and the

⁷ See pp. 338 and 360 of this volume.

⁸ See pp. 487 ff. of this volume.

variations cover more and more of the important factors involved, specific cause-and-effect relationships can be isolated and established as generalizations. The federal Treasury's unhappy experience with bond issues during the Civil War, as contrasted with the successful marketing of the World War I Liberty Loans, for instance, is an eloquent commentary on the importance of marshaling and firing patriotic sentiment to create a popular market for war loans.

But historical instances and analogies must be used with supreme care. The student of Public Finance must remain aware that *post hoc non est propter hoc*—that the accident of historical occurrence does not, solely of itself, establish causality. Contributing factors present in the historical case may be absent in the present, or vice versa. Too often the hasty scholar or the willful propagandist forgets that "circumstances alter cases," and improperly draws parallels between past and present events. The failure of state income taxes prior to 1911, for example, is not an argument against the present-day levy of state income taxes, for improved administrative technique has been developed which makes possible today what was impossible forty years ago.

Inductive inquiry, whether historical, descriptive, or statistical, is likely to give a series of disconnected conclusions, hardly to be considered a system or science. These scattered truths must be coordinated and related by deductive reasoning, and a background for them must be built up by correlating them with the allied social sciences and arts.

Syllogistic reasoning, progressing from generalizations to particular circumstances, is the fundamental method of deductive inquiry. Thus, given the legal generalization that the states may not levy taxes on the acts of importation or exportation, it can be concluded that a particular state may not levy a license tax on importers and exporters. The syllogistic method of inquiry is obvious, and need not further claim our attention.

HISTORY OF PUBLIC FINANCE

Public Finance is the study of fiscal systems. Since fiscal systems presuppose the existence of the political organisms known as States,

Public Finance as an art and a science could not come into existence until the progress of civilization produced States.

Public Finance in antiquity

Archeological studies indicate that, besides the Egyptian, several of the early east Mediterranean, Mesopotamian, and Indian civilizations achieved a high degree of political integration. In marked contrast with the revenue policy of modern States, the fiscal systems of these early civilizations depended heavily upon tribute from conquered peoples and slave labor employed by the State. None the less, the ancient governments developed broad systems of indirect taxation, whose major elements were charges on land transfers and on commercial transactions. Imperial Rome levied an inheritance tax and a general sales tax.

Writings and treatises from the Roman and Greek civilizations have survived to modern times, but the written word of older civilizations has, with a few fragmentary exceptions, perished. Not improbably, the technical knowledge of fiscal administrators in these older civilizations was embodied in one or another written form; such documents have not persisted through the millennia, but that does not disprove their having existed. From the Greek era there is left a short treatise, the *Athenian Revenues*, by Xenophon; incidental comments on matters fiscal are found in the writings of Plato and Aristotle. Analysis and criticism of Roman fiscal systems are encountered frequently in the writings of the Roman historians and commentators.

Public Finance prior to Adam Smith

When Imperial Rome collapsed, western Europe entered upon a period of political anarchy which eventually crystallized into the semigovernmental order known as the feudal system. Fiscal systems, and all possibilities of a study of Public Finance, ended with the disappearance of the State as a factor of political organization.

From the eleventh century onward, a group of commercial cities grew and flourished in Italy and northern Europe. In time, they gained political independence from the feudal lords under whose

protection they were first established, and became true city-states. Their governmental activities and their revenue requirements were extensive. Treatises on Public Finance were written in several of these Italian and north European city-states; the most noted were written at the close of the fifteenth century by the Florentine historian Guicciardini and the Neapolitan councilor Diomedea Carafa.

Fiscal problems of increasing magnitude were placed before the thinkers of Europe with the establishment of national states in western Europe and the growth of principalities and kingdoms in central Europe. Jean Bodin, the French writer, examined the sources of public revenue in his study on political science, *Six livres sur la république*, published in 1576. Mercantilist disputation in seventeenth-century England stimulated a flood of controversial literature upon the effects of excise taxes. The outstanding work was *A Treatise of Taxes and Contributions* (1662) by Sir William Petty. To this period also belong the fiscal writings of John Locke, William Temple, and Charles Davenant.

During the eighteenth century, significant contributions to the study of Public Finance were made in France, in Germany, in Austria, and in England. Vauban's *Projet de dîme royale*, a criticism of the French system of indirect taxes, which appeared in 1707, was the most important of the French contributions. Boisguillebert, writing in the same year, and Montesquieu in his *L'esprit des lois* (1748) also gave close attention to the tax system of the French monarchy. The Physiocrats Quesnay, Mirabeau, and Turgot, prominent in the second half of the century, proposed a single tax on land to replace all existing indirect taxes, which, they believed, were in all cases shifted to the land owners.

Eighteenth-century German writers on Public Finance were, without exception, chamberlains and ministers of the reigning petty kings and princelings of central Europe. Their major interest was the practical technique of raising revenue for their royal masters; they dealt with the problems of Public Finance essentially from the position of the official and administrator. Their viewpoint having been that of the royal chamber, they have been given the group name, "Camerallists." Von Justi, author of *Staatswirtschaft* (1775)

and *System des Finanzwesens* (1766), is most frequently cited as representative of the group.

To the English writers of the eighteenth century, Public Finance was incidental to the broader subject of Mercantilism. They reached their culmination in Sir James Steuart's *Principles of Political Economy* (1767).

Adam Smith and the English school

Adam Smith's *The Wealth of Nations*, published in 1776, was a broadside attack on the accepted doctrine of Mercantilism rather than a general textbook exposition of the principles of Economics. Book V of *The Wealth of Nations* was devoted to questions of taxation, but it was not to be expected that Adam Smith should present a full and well-rounded study of all phases of Public Finance. None the less, such was its broad scholarship and keenness of argument, that both in England and on the Continent it became the foundation for subsequent study on Public Finance.⁹ The great and lasting contribution of *The Wealth of Nations* to the science of Public Finance was its emphasis upon the role of principles of equity in the distribution of tax burdens. Smith also emphasized the relationship between Public Finance and Economics, and made frequent reference to the economic effects of particular taxes, but he developed no broad theories of incidence.

English economists after Adam Smith devoted occasional attention to the problems and principles of Public Finance. First of a series of studies in this field was David Ricardo's *The Principles of Political Economy* (1817). To the extent that it dealt with problems of taxation, Ricardo's work complemented *The Wealth of Nations*, since it exploited the field of tax shifting and incidence. Subsequent English writers in this field were not numerous, but a distinguished line may be traced through McCulloch and J. S. Mill to C. F. Bastable and A. C. Pigou. They continued essentially within

⁹ Unfortunately, the great authority of Adam Smith's name has been unfairly borrowed—and still is all too frequently appropriated—as authority for restrictive views on the scope of governmental functions and on the propriety of various forms of taxation. The "fundamental fiscal principles" of Adam Smith were pertinent for the last quarter of eighteenth-century England. For twentieth-century America their interest can be only historical.

the tradition established by Smith and Ricardo, occupied themselves with the theories of proper distribution and incidence of taxes, and gave little attention to the history of taxation or to its social or administrative aspects. During the last thirty years of the nineteenth century, several able writers turned their attention to the special problems of local finance, and enriched fiscal literature with valuable studies on this subject.

Public Finance on the Continent

Nineteenth-century French writers were interested in the theoretical aspects of Public Finance. P. Leroy Beaulieu's great treatise, *Traité de la science des finances* (1877), was an encyclopedic presentation of contemporaneous scholarship rather than a further probing into fiscal problems. Two other general studies of public finances by French economists—G. Jeze's *Science des finances* (1896) and E. Allix's *Traité élémentaire* (1907)—achieved an international reputation. R. Stourm's trail-blazing book *Le Budget* (1889) became a classic. Since World War I, French students of Public Finance have been acutely concerned with problems of fiscal administration.

Germany was the seat of the greater part of nineteenth-century research and scholarship in Public Finance. A number of treatises on Public Finance, all strongly influenced by Adam Smith and Ricardo, appeared in rapid order early in the century; the most important of these was the *Grundsätze der Finanzwissenschaft* (1832) by K. H. Rau. These early studies not only covered the subject of taxation, but extended to problems of governmental expenditure, borrowing, and credit.

Toward the middle of the century, German fiscal scholarship made several new departures of great importance to the future study of Public Finance. Together with other economic subjects, Public Finance was taken up by the "historical school" of German economists. While the work of Schmoller and Schäffle bore only incidentally on Public Finance, many of their pupils spent a lifetime of research upon the history of taxation, ancient and modern; under the editorship of Georg Schanz, the pages of Germany's great fiscal

periodical, the *Finanz Archiv*, were ever open to studies of tax history. A second divergence of German scholars from the Adam Smith tradition was the propensity of several writers—noteworthy, Von Stein—to treat Public Finance as a branch of governmental or political science. For ultimate authority, they looked to the Cameralists rather than to Adam Smith. Finally, through the far-reaching influence of Adolf Wagner, the social aspects of Public Finance—the possibility of utilizing the fiscal elements of government as agencies of social reform—came to be recognized.

During the latter part of the nineteenth century and the first quarter of the twentieth century, Italian scholars also were active in Public Finance. To some extent, the Italian fiscal economists derived their inspiration from German writers, and devoted considerable attention to historical studies and to the social aspects of taxation. Another source of inspiration for the Italian writers was the Austrian development of the doctrine of marginal analysis; unfortunately, in pursuing this line of analysis, the Italian economists tended to forsake all practical realities for tenuous speculation. The most significant Italian fiscal study was A. Graziani's *Manuale della scienza delle finanze* (1893).

American writers on Public Finance

When a national government finds difficulty in disposing of a revenue surplus, as did the American federal government during the 1880's, scholarship in Public Finance is likely to go begging. Not until the close of the century did American writers make any significant contributions to the study of Public Finance. Then, within fourteen years, from 1887 to 1900, there appeared six important American studies. Three of these, *Public Debts* (1887) and *The Science of Finance* (1898) by Henry C. Adams, and *The Theory and Practice of Taxation* (1900) by David A. Wells, showed a derivation from the English school of fiscal thought. The other three studies, *Taxation in American States and Cities* (1888) by Richard T. Ely, and *The Shifting and Incidence of Taxation* (1892) and *Progressive Taxation* (1894) by Edwin R. A. Seligman, were clearly influenced by the German doctrines of scholarship, emphasis

being laid upon a historical approach, and consideration being given to the social aspects of taxation.

But neither the English nor the German school of fiscal thought gained predominance in the United States. In this country, the federal government, the 48 independent state governments, and the 176,000 local governments having fiscal semi-independence, present a factual problem so stupendous that American students of Public Finance have found little opportunity for extensive studies into the general history and principles of taxation. Pressing problems of state and local finance have drawn American fiscal scholarship into localized fields, into studies of the fiscal systems of individual states, or into critical analysis of fiscal problems particularly affecting the states and the local governments. Many of our fiscal administrators are keen scholars of a "cameralist" type. Many of our ablest academic fiscal scholars are drafted into administrative harness or serve on "advisory commissions." In consequence, until very recently American fiscal scholarship was held fast to the immediate and the practical. Theoretical first principles have been accepted blindly from classical sources, or have been improvised casually in the course of rationalizing arbitrary conclusions.

The past decade has witnessed a noteworthy channeling of American fiscal scholarship into inquiry upon the social and economic repercussions of governmental expenditure, taxation, and borrowing. The Twentieth Century Fund has published several significant studies on this subject. Some of the recent articles in this field constitute outstanding contributions to theoretical literature of Public Finance.

PART I

GOVERNMENTAL EXPENDITURE

CHAPTER I

Scope of Governmental Expenditure

SHOULD the federal government expend funds on battleships—or to dredge a Mississippi River channel—or upon a work relief project? Should a state government pay for judges' salaries—or for concrete motor highways—or for unemployment insurance? Should a county spend for school purposes—or for poor relief—or for swamp drainage? Should a city hire and pay firemen—or construct a water-supply system—or provide a children's playground?

Questions such as these are ever-recurrent vital political issues. They arise in the debates of Congress, of state legislatures, of local councils. They are the theme of countless published articles and editorials. They are frequently the subjects of election controversies.

What answers does the science of Public Finance give to these specific and pertinent questions? None! Such questions are facets of the fundamental query: What are the proper functions of Government? And the many attempts to frame a categorical theory of governmental functions have been without success, since there are no provable generalizations upon human nature to serve as first premises for any of the arguments.

POLITICAL THEORIES

Political thought ranges between two poles—the anarchist State in which government would be practically nonexistent and in which all necessary economic and social controls would be exercised by voluntary groupings of individuals, and the communist State which would exercise all ownership and operation of productive property and be the source of all economic enterprise. From the anarchist ideal stem the *laissez-faire*, individualistic doctrines of governmental activity, which until recent years dominated English and American writings on Public Finance. From the communist ideal is derived

the growing body of "collectivistic" proposals and legislation, in the United States as well as abroad, for government intervention and activity in fields "touched with a public interest."

Individualistic doctrine

Most early nineteenth-century writers on Public Finance held that the State should act only as "passive policeman," guaranteeing to each individual the fullest freedom for the exercise of his faculties compatible with the equal freedom of all others. When, said these writers, the State assumed to do more than protect the individual in the exercise of his faculties, when it assumed to participate positively in the development of human nature or of human capacity and character, it defeated itself and retarded the development of the "fullest life." Free public education was frowned upon as being outside the proper sphere of the State's activities. Roads and canals could be constructed better by private corporations. Government expenditures for social welfare were beyond the pale of orthodox thought. As one conservative English parliamentarian wrote in 1830:

Every particle of expense that is incurred beyond what necessity absolutely requires for the preservation of the social order and for protection against foreign attack is an unjust and oppressive imposition upon the public.¹

But the march of events contradicted these conservative doctrines. In an era of swift development, no sooner had these observers finished dogmatizing about the limits of State action than they had the questionable pleasure of seeing their dogmas set aside in favor of necessity or expediency.

Later writers of the English and French schools of political thought discarded the rigid yardstick of their predecessors. They compromised between social conservatism and the progress of the times by classifying governmental functions as primary and secondary. The primary functions were military and civil protection, and the civil administration of government. All other activities—support

¹ Sir Harry Parnell, *On Financial Reform* (London, 1830), p. 118.

of the schools, building and maintaining roads, all forms of public improvements, all forms of social welfare activity—were classified as secondary. Expenditure on the primary activities of government was justifiable *per se*. Expenditure on the secondary activities was to be looked upon askance. If a great public benefit was clearly and unmistakably discernible, then expenditure on secondary governmental activities might be approved, but approval could be accorded only if such benefit were established beyond reasonable doubt.

Collectivistic doctrine

At the ultimate extreme of communist doctrine would be the propositions that all economic and many noneconomic activities are "touched with a public interest,"² and that the State should absorb and embrace all, or nearly all, human effort. Given the wish that is father to the thought, some element of "public interest" or "social benefit" can be discerned in practically every activity. After all, the "public," or some part of it, has an "interest" in every element of production and manufacture, in every merchandising procedure, in every standardized or individualized service rendered.

Extreme communism, like anarchism, is rarely advocated. But just as a moderated selection of anarchist principle could be erected into the practical political philosophy of "individualism," so a moderated communism—or "collectivism," as its proponents prefer to call it—could be developed into a practical political agenda. In piecemeal fashion, this "collectivist" doctrine has had incidental acceptance in the United States throughout this country's history, and has in recent years obtained wide popular and official support.³

As far back as colonial times education was accepted as a government function. A passion for "internal improvements" during the first third of the nineteenth century led the states to construct highways and canals; later the states assisted railroad and banking development. Free hospitalization, maternity assistance, old-age pensions, and unemployment insurance are expansions upon earlier,

² The term is used here in a loose popular sense, not in its stricter legal connotation.

³ Cf. Herbert D. Simpson, "The Problem of Expanding Governmental Activities," *American Economic Review*, supplement, Vol. 24, pt. 1, March 1934, pp. 151-160.

rudimentary poor relief. Agricultural aid has assumed protean forms. Group disasters are now held to be matters of public concern, and the relief of the victims through governmental agency, a social obligation. Through the Federal Reserve System, the Farm Credit System, the Home Loan System, and the Home Owners Loan Corporation, the federal government has become the major purveyor of credit. TVA is discussed as a forerunner of still greater "control" projects in the Mississippi Valley and the Far West. Consideration has been given to the suggestion that a long-term federal public works program be maintained to give relief employment, and, through the establishment of regulatory authorities—the Interstate Commerce Commission, the Federal Trade Commission, the Securities Exchange Commission, and other federal bodies, a horde of state public utility commissions, boxing commissions, racing commissions, and innumerable municipal departments and commissions of markets, plumbing, elevator inspection, etc.—the protective function has expanded from its earlier simple soldier-policeman status to an all-embracing guardianship of the individual in his personal and business capacities.

Critique

Anarchism and communism as theories of government are susceptible of neither proof nor disproof. The doctrines of individualism and collectivism, derived from them, are likewise innocent of logical foundation. Any governmental activity can be either condemned or approved, depending upon the principle used as first premise. A writer who believes with the individualists that "the least government is the best government," will obviously condemn government expenditures for unemployment relief or regulation of security issues. Another, who believes that it is a matter of "public interest" to maintain the physical condition and morale of the unemployed and to protect the untutored investor, will just as obviously approve such expenditures.

Political philosophy, we must conclude, provides no yardstick for determining the valid functions of the State. Bases for arguments pro and con may be had, but so long as the first premises are bare

credos, the arguments must remain inconclusive. Popular opinion, which gives little thought to political first premises and less heed to logical argument, but obeys deep group-emotional urges, has during the past fifty years swung steadily and at an accelerating pace from its earlier individualistic attitude toward governmental activity to an increasingly collectivistic acceptance of broadened governmental service. President Cleveland could, with general approval, veto an appropriation of \$25,000 to buy seed corn for Texas farmers ruined by drought, with the statement, "I veto this appropriation because there is no warrant in the Constitution of the United States for taking the funds which are raised from the taxes and giving them from one man to another, and I further veto it in order to teach the lesson that while the people support the government, the government does not support the people." Today we accept federal appropriations for farm aid as a matter of course; likewise as a matter of course we accept federal expenditures on antitrust investigation, state expenditures on unemployment insurance, municipal expenditures to operate radio stations.

ECONOMIC DOCTRINES

Economics has endeavored to mediate between the individualist and collectivist doctrines of governmental activity. It has analyzed the element of "productivity" in governmental functions. It has sought, in the principle of "comparative social benefit" or "comparative social utility," a yardstick by which to approve or condemn governmental activity. By measuring governmental expenditure against various bases, it has endeavored to establish quantitative standards for comparing public functions as between governments and over periods of time. And finally, some attempt has been made to define the "economic limits," or possible maxima, of governmental expenditure.

Quite evidently, these economic contributions fall far short of establishing definite canons on the scope of governmental activity. At best and at most, they clarify or raise some side issues but they do not settle the basic political arguments.

Productivity of governmental expenditure

Conservative writers occasionally attack governmental activity as "unproductive." They contend that the State takes from its citizens funds which otherwise would be used to grow food, to build houses, to manufacture shoes and ships and sealing wax. These funds are spent on salaries and for materials consumed by the various administrative departments. Funds which might be devoted to "productive" use have been diverted to "nonproductive" activity. This economic argument is used to bolster the political argument, already noted, that the sphere of governmental activity should be restricted to a minimum.

The controversy turns upon the definition of the term "productive." If the term is limited to the production of tangible commodities, governmental activity will certainly appear less "productive" than individual activity. A larger proportion of governmental than of private activity results in the creation of intangible services. Although some governmental functions result in material products—weapons forged in arsenals or highways built by states—immaterial services such as judicial process, police and fire protection, education, social relief, and public utility regulation predominate. But Economics no longer identifies "productive" with "material." All nondetrimental and nonparasitic activities which satisfy material or immaterial wants of the community are now classified as "productive." The actor is as "productive" as the bricklayer; a member of a federal commission or a teacher is no less creative than a manufacturer of spools.

Governmental and private activities are to be judged by the same standards. A governmental function, like a private enterprise, may occasionally prove detrimental. Bad legislative or administrative judgment may result in a project which not only fails to produce the desired result but which directly or indirectly injures individuals or the community. Should a faulty dam crumble, a city would lose its water supply, and a countryside would be flooded. And sometimes a sinecure governmental position, preserved as a "political plum" by a dominant party machine, may be purely wasteful, with-

out discernible benefit to anyone but the incumbent. But these accidentally detrimental or casually wasteful activities are exceptions. Normally, the service resulting from a governmental expenditure benefits some, many, most, or all its citizens. Schools serve both the children who attend and the social structure of which at maturity they become component parts. A playground which promotes the health and protects the moral character of city children has produced values far above any monetary measure. In this generation, the care of the sick, the insane, the aged poor, and the unemployed is deemed an obligation of society. Those state and local governments which provide for the care of these classes are then definitely fulfilling a social want. By the current standards of Economics, these services are "productive."

Questions may be raised on the "productivity" of military and naval preparations. Are not such activities "unproductive" or even detrimental, in that they are an ever-present inducement to war? Is not war, an outstanding function of national government, the supreme example of "unproductive" detrimental governmental expenditure? There are no canons of judgment for answering this question. A defensive war, it may be argued, cannot be viewed as detrimental, since preservation of the nation is the supreme benefit; even offensive warfare may be justified on the ground that "a strong offensive is the best defense." On the other hand, it is frequently argued that there is no such thing as a "defensive" war. The issue must remain open. Whether the billions of dollars which the federal government has spent upon its army and navy, upon "defense," and upon warfare are to be accounted supremely beneficial and, therefore, supremely "productive," or whether they are to be considered supremely detrimental, depends upon the individual's personal viewpoint and prejudice.

Doctrine of "comparative social benefit"

To establish governmental expenditure as "productive" does not settle the issue of the proper scope of governmental activity. Some basic questions are still unanswered. Should any specified activity be undertaken by the State or the individual? Should the State as-

sume a specified function though it thereby deprive individuals of funds which they would otherwise have devoted to some other class of consumption or production? Economics has sought a solution to these problems through the doctrine of "comparative social benefit."

As modern fiscal writers frequently phrase the idea, governments are agencies through which society makes a certain class of expenditures—those producing a general social benefit. Such social benefit will be derived from any undertaking "touched with a public interest." What activities are "touched with a public interest"? Here again is the ever-present individualist-collectivist issue. The fiscal economist leaves the question unanswered.

Assuming some degree of "public interest" in State functions, funds for them must be diverted from the individual expenditures and savings of various classes of the population. In the long run, allowing for public borrowing and its repayment, State expenditures constitute a corresponding reduction of funds available for individual expenditure and saving—if my income tax is increased to help pay for a rearmament program, or if my property tax is raised to provide for an expanded school system, obviously I am left with less funds to buy the dresses my wife would like to wear, or to spend on amusements, or to invest. Is the social benefit derived from the government's expenditures greater or less than the personal benefit which the original holders would have derived from the use of these funds? If greater, the governmental expenditure is justified. If less, the function must be condemned. This principle of "maximum social advantage," as one English writer names it, becomes the measuring rod of governmental activity.

Some American fiscal economists achieve a finer definition of the "social benefit" concept by applying to it the principle of marginal utility. As a government service is increased, the marginal utility or "marginal social benefit" of each additional increment to the service declines. Yearly provision by a city of 10,000 gallons of water per resident—barely sufficient to cover minimum living and sanitary requirements—would be absolutely essential to the existence of the city. Provision of 50,000 gallons per person, permitting liberal use, would produce some additional social benefit, but not proportion-

ately as much as the initial 10,000 gallons. More than 100,000 gallons per person might be of no use whatsoever to the residents of the city. Any single governmental function is subject to the law of diminishing utility. So also is the sum total of governmental functions. If a governmental unit is spending \$200,000,000 a year where formerly it spent only \$100,000,000, surely it is a fair assumption that some at least of the additional services provided by the extra \$100,000,000 are less vital, less valuable, to the community than the services provided by the original \$100,000,000.

Meanwhile, as the marginal utility of successive increments of governmental service tends to diminish, the marginal value to the taxpayers of the increasing revenues necessitated by the greater expenditure increases. Higher taxes cut the net income of the taxpayers, reduce savings and personal expenditures, and enhance appreciation of the marginal personal satisfactions to be obtained by those savings and expenditures. The sacrifice imposed on a taxpayer by successive increases of his tax burden does not increase proportionately but geometrically; should the cumulation of tax increases push his remaining income below the level of material subsistence, he might well feel that the last increment of taxation was intolerable, although in actual amount it was no greater than an earlier increment that had seemed only inconvenient or annoying.

According to the "marginalists," the benefit of the last increment of governmental expenditure on any function should be measured against the marginal benefit of individual expenditure or saving of a like amount. The establishment or enlargement of a governmental function is justified only when the social benefit of the final dollar spent upon it outweighs the sacrifice imposed upon the taxpayer who surrendered that dollar. If the taxpayers would suffer less from the deprivation of an additional fifty thousand dollars than the public would gain from its expenditure by the government, then it should be appropriated. If the balance lies the other way, the governmental function is without justification.

The "marginal" doctrine can be applied not only to government expenditures as a whole, but to particular functions in the field of government activity. Shall a particular \$50,000 that can be included

in a municipal budget be appropriated for schools, or street lighting, or parks, or poor relief? Or to which function shall an obligatory \$50,000 budget cut be applied? Look at the marginal social benefit produced by each particular function, say the "marginalists," and add or subtract your \$50,000 according to the maximum advantage derived from its application.

The social benefit concept of governmental expenditure, particularly when it is neatly expressed in its "marginal utility" form, has a deceptive air of definiteness and finality. Apparently, the propriety of any proposed governmental activity can be determined with no other assistance than that of a calculating machine. But how shall the marginal social benefit of a proposed governmental undertaking actually be measured? What yardstick can scale the social benefit of the last \$10,000 spent by a government on boll weevil elimination, or printing the *Statistical Abstract*, or paving a street, or distributing poor relief? What scale will weigh the respective merits of \$50,000 spent on special school classes for mentally deficient children as against \$50,000 spent on a traffic signal system to reduce street accidents?

Not only is there no way to calculate the marginal social benefit of a governmental expenditure, but there is no measure for the social or personal sacrifice involved in the corresponding tax payment. Psychologists have yet to develop a yardstick for individual satisfactions, let alone a measure of composite monetary appreciation. What unit can be used to measure the sacrifice imposed upon my wife by foregoing a new dress or upon me by foregoing a motor trip because of the increased income and property taxes that the expansion of some governmental function causes me to pay? Furthermore, with the disutility of what tax payment shall the marginal social benefit of a public expenditure be compared? One tax system could wring the bulk of government revenue from the lowest income groups, reducing their expenditures for the bare necessities of life, driving them to submarginal standards. Another tax system could skim the revenue in question from higher-level incomes, checking saving and possibly capital investment, and reducing the consumption of luxuries. Patently, the different tax systems will

create variant social and personal disutilities for the tax payment in question—different intensities of sacrifice are involved when taxes compel the poor to restrict their expenditure on necessities and when they cause the rich to forego certain luxuries or reduce their new investment.

Students of Public Finance must put by the doctrine of “comparative social benefit,” with or without its “marginal utility” refinements. It rests upon a series of quantitative concepts which cannot be given quantitative expression. No valid conclusions with respect to any particular governmental function can be derived from it.

Limits of governmental expenditure

Some writers have suggested that, regardless of social benefit or desirability, a government's functions are definitely limited by its economic background—the wealth of the nation or region. A community cannot divert to governmental purposes so much of the income of its residents that they are left without the wherewithal for food, clothing, and shelter. A national government cannot divert resources and man power beyond the point where an insufficiency of the material necessities of private living results.

These observations are particularly pertinent to local finance. There are communities throughout the United States so poor that the most crushing tax levies could not produce enough revenue to finance minimum standards of education and other essential governmental functions. As we shall see,⁴ however, this situation does not necessarily limit the governmental functions performed for the community. They may be taken over by a central government with greater resources at its command, or the local unit may be assisted by a state grant-in-aid or a share of state-collected taxes.

As applied to national or state governments, the theory of an absolute economic limitation upon governmental functions has several qualifications. No matter how many billions of dollars were absorbed by taxes, if these same billions were paid out as “transfer” expenditures—debt service, soldiers' bonuses, old age pensions, un-

⁴ See Ch. XXIX, pp 717 ff. of this volume

employment insurance—the country's power to produce and consume would be undiminished. The theory of limits cannot be applied to "transfer" expenditures.

Furthermore, whenever a governmental activity replaces or anticipates a private activity, the resources and income which would have been applied to that activity can be diverted to the government without reducing the economic standards of the country or the community. Residents of a city are no poorer if the city takes over a toll bridge, opens it to free passage, and collects from the taxpayers the same amount that was formerly paid as tolls. To the extent that federal funds spent on Department of Commerce reports save business firms from paying the same or greater amounts to private research agencies, taxes supporting this function subtract nothing from the resources of the country.

Even apart from these qualifications, when the theory of limits is applied to national governments, it is too elastic to have much meaning except in war or other emergency periods. Germany's experiences during the first World War and again from 1936 to 1940⁵ show that a people can be held to a semistarvation diet for several years, their clothing requirements can be reduced to mere body covering, and they can be compelled to forego all the luxuries and semiluxuries of civilized living, while the government commands men and resources to the service of national defense or offense. Under such circumstances, a real economic limit of government activity—the reservation of such fraction of the national income as is necessary to purchase the wherewithal to maintain the producing elements of the civilian population at functioning efficiency—may be reached. For the United States it has been calculated that, with prices at the 1940 level, federal expenditure for war purposes could not exceed fifty to sixty billion dollars out of a national income in the neighborhood of ninety billion dollars,⁶ for a national income expanded by inflation or increased industrial effort, the maximum "war potential" would, of course, be higher. In normal times, however, the margin of na-

⁵ The Conference Board, *Essential Facts for Fiscal Policy* (the Board, New York, 1941), p. 10.

tional surplus is so much wider than the scope of government spending activity, that the latter is little likely to press upon the former.

Revenue as a current limit on governmental expenditure

Fiscal writers frequently observe that, unlike individuals, governments tailor their revenue systems to fit their expenditure programs.⁶ Administrative officials and legislators first map out a program of accomplishment. Next, the cost of such a program is calculated. As a final step, those adjustments in the revenue system which will provide the funds necessary for the expenditure program are considered. Under such procedure, it is argued, revenue necessities are little check upon governmental expenditure.

This theory that expenditures condition revenues does not apply to local fiscal practice. Cities, counties, and other local units generally operate under tax limit laws.⁷ Normally, they levy and spend the maximum allowed. Their governing officials may heartily wish to expand some function, spend more—but the tax limit is absolute. Legislative lobbying occasionally obtains a relaxation of the limitation, bond issues may cover exceptional capital outlay, but in the normal course of events the limitation holds. Revenues most certainly condition current expenditures for local units.

Even the federal government and the state governments, unchecked by tax law limitations, are not free to engage in every wild and crackbrained program of expenditure which may occur to an irresponsible legislature imbued with the idea that a government first determines expenditures and then raises revenue sufficient to cover the costs. Patient though taxpayers are, extreme extravagance on the part of government can provoke sporadic political protest. In the long run, allowing for all delays made possible by borrowing, most governmental expenditures must be financed by taxation. The imposition of too heavy a tax burden sometimes brings the individ-

⁶ To take a random recent statement of this idea "[The burden of taxation] is settled when the appropriate legislative body determines upon the functions that the Government is to perform and their cost; it is a matter of the Budget. When once the cost is fixed, taxation must, sooner or later, foot the bill."—Fred R. Fairchild and associates, *Forest Taxation in the United States* (United States Department of Agriculture, Miscellaneous Publication No. 218, 1935), p. 635.

⁷ See p. 397 of this volume.

uals and the political party responsible into the disfavor of the voters.

Measures of governmental expenditure

To compare the role of government in the economic life of several countries or states, or to compare the relative roles of governmental activity within some political unit over a span of time, we must measure governmental expenditures against some common base. The ideal base would be "value produced," and we would then compare the value produced by governmental activity as against that produced by private activity within political units or in selected years. But we have no adequate measures, monetary or otherwise, of the intangible noncommercial values produced by governmental activity. We must, therefore, use the bases made available by statistical collation—population, wealth, and income.

Of the three bases, income is the most useful. Monetary figures for governmental expenditure do not, of course, measure its value, so that a comparison of governmental expenditure and national or state income cannot indicate the relative accomplishments of governmental and private activity. But to the extent that governmental expenditure represents a diversion of funds, materials, and services from private use,⁸ the comparison of income more or less reflects the division of effort between the two classes of activity.

Estimates have been made of the national income of the United States and of the leading European countries. In some cases the calculations carry back a half century or more. Imperfections of the basic data available and, sometimes, questionable statistical procedures deprive most of these estimates of any claim of intrinsic validity; but where continuing series of annual figures have been calculated by a uniform method they have some comparative value. For whatever the comparison is worth, total governmental expenditures of different countries, or the total governmental expenditures of any particular country over a period of years, may be compared

⁸ As will be shown in the next chapter, governmental expenditure is not a pure diversion of funds, materials, and services from private use. "Transfer" expenditures merely shift funds between individuals. Other expenditures may, under special circumstances, create an additional element of private income.

with national income. The ratios so obtained are useful for showing in broad outline and subject to various qualifications the relative development of governmental activity as between countries, and the developing relation of governmental to private activity for a particular country over a period of years. From time to time, during the past fifteen years, attempts have been made to subdivide the national income of the United States by states; as yet, the calculations cover only isolated years and are of trifling worth. No income figures are to be had for smaller political units.

Expenditures of particular state and local governments in the United States must be measured, if at all, against wealth or population. An expenditure-to-wealth ratio means little as a measure of governmental functions. State by state estimates of wealth, though frequently made, are so permeated with inaccuracy because of the unsatisfactory character of the basic data as to be worthless for any comparative purpose. And even if state or local wealth figures could be accurately calculated, wealth is hardly a standard for comparative measurement of either the need or the burden of governmental expenditure. Figures on per capita governmental expenditure have even less comparative significance. But, they are better than no measure at all, and may be used to disclose very broad trends.

CONCLUSION

Political philosophy gives no help, economic theory little help, in defining the scope of State activity and hence of governmental expenditure. Economists and political theorists are as impartial as munitions makers—they supply explosives to both sides of many controversies. The student of Public Finance must consider the problem insoluble. There are no canons which determine what the State can or cannot do, for what purposes it should or should not expend the funds it raises by taxation and borrowing.

Practical politics, reflecting unreasoned popular opinion or actually molding such opinion, rather than political or economic theory, supply the explanation of the current functions of any governmental unit. Enthusiasts for some cause organize as a "pressure group,"

propagandize sufficiently shrewdly to gain popular support or at least a latent popular sympathy, plant a lobby at the state or national capital, threaten, wheedle, bulldoze, cajole, and tyrannize a sufficient number of legislators into voting their project. Or a less idealistic but more practical group, seeing some indirect but substantial profit for themselves if a government will undertake some function, manufactures a high-principled social reason for it, employs and pays a professional lobbyist, and negotiates the voting of the new function. Unless the proposed project will injure some definite economic group, the legislature hears only one side of the case, is persuaded that through the lobby it is truly hearing the "voice of the people," authorizes the new function, and votes an appropriation. If the proposal rouses opposition interests, a battle royal of propaganda and lobbying ensues in which lobbying skill and the chance strategy of party politics are more decisive factors than social philosophy or economic science.

No impersonal legislative consideration of the personal sacrifice involved in military service determined Congressional passage of veterans' pension and bonus laws; senators and representatives alike obeyed the commands of a superbly effective veterans' lobby. Likewise vigorous campaigns by progressive pressure groups, rather than an awakening of social conscience on the part of state legislatures, motivated the creation of the various state bureaus of child welfare. State school-aid laws are passed because of lobbying pressure applied by teachers organizations and parent-teacher associations. New school buildings are sometimes authorized because a bank or investment house is eager for the commission on selling the bonds, or because an influential property owner has a school site to sell, or because an important contractor foresees a substantial profit in the construction. And a city frequently cuts streets, runs sewers, and provides other facilities for an outlying wasteland because an influential realtor hopes thereby to create a salable "development."

Once established, public functions are likely to be continued indefinitely, whether or not the need for them persists. In addition to some "social benefit" inherent in, or read into, any governmental activity, there are probably also substantial private benefits to indi-

viduals or groups—among others, the officeholders and public employees performing the function. These beneficiaries soon regard their advantage as a vested interest. Any proposal to abolish or reduce the expenditure rouses their vociferous protest, and they constitute themselves a “pressure group” to retain the function. Unless a taxpayers’ economy organization can raise a stronger counter-propaganda, the function continues. Witness the protracted struggle of the beneficiaries of the federal temporary “recovery” program to convert it into a permanent “relief” project after the emergency that initiated it had passed. Witness the persistence of the costly antiquated county-borough administrative organization in New York City, for the sake of the political patronage involved in various duplicatory and unnecessary offices and jobs.

CHAPTER II

Economics of Governmental Expenditure

WHEN the governmental bodies of a country spend \$16,000,000,000 in the course of a year, as did the American governments in the "normal" year 1937—and even more so when \$18,000,000,000 of projected armament expenditures carry the federal total to over \$25,000,000,000 as anticipated for 1941-1942—the general economic life of the people is certain to be profoundly affected. Individuals and classes derive benefits which would not otherwise have been theirs. Some industries profit from the governments' activity, others suffer from the diversion of private purchasing power. Credit, currency, and prices may be vitally affected. The flow of private funds into the capital market may be modified or seriously checked. Distribution of wealth and income among economic classes and social groups may be altered.

Reaction and interaction of governmental expenditure extend through the entire economic and social structure of a country in an infinite series of ramifications. This endless web of cause and effect cannot be examined in every minute detail. At most, the student's attention can be directed to a few broad aspects of the problem.

CLASSIFICATION OF GOVERNMENTAL EXPENDITURE

Twice in the preceding chapter we had occasion to distinguish between "transfer" and "public consumption" expenditures; in the present chapter we shall again severally analyze the two classes of payments. The two following chapters will be devoted to a "functional" analysis of the expenditures of the federal, state, and local governments. Subsequently, in the discussion of budgeting and in the chapters on borrowing, public expenditures will be classified into

“capital” and “current.” Other classifications will appear in the course of our study of Public Finance.

Nineteenth-century fiscal writers devoted considerable space to the subject of the *proper* classification of governmental expenditures, but no two ever agreed upon the same classification. A basis of classification, it is now generally recognized, is not absolute; it should be relative to the purposes which the classification is intended to serve. Hence, modern fiscal economists waste no time formulating some absolute classification of public expenditure, but construct as many different classifications as may serve the purposes of their inquiries.

A governmental accountant classifies items of public expenditure according to the specific “funds” provided by legislative enactment, in order to obtain a balance for the revenues going into and the disbursements made from such funds. A classification according to objects of expenditure—materials purchased, wages of unskilled labor, salaries of officials, insurance on public buildings, and so forth—facilitates inquiry into the efficiency of governmental activities. When governmental expenditures are classified according to governmental functions, the reader can interpret what the government is doing at any particular time and how its activities are changing.

Functional classifications of governmental expenditures vary with the emphasis sought in the presentation of the material. If the presentation is to provide a background for a discussion of governmental borrowing, expenditures may be classified as “current” and “capital,” or as “recurrent” and “nonrecurrent.” If the object is a discussion of whether particular current activities should be financed out of the general tax revenues or by special charges attached to the activity, the classification of governmental activities may separate those conferring only general social benefit and those conferring supplementary distinguishable individual benefits. Actually, there can be as many listings, combinations, and recombinations of governmental activities and expenditures as there are writers willing to occupy themselves with the problem.

In the governmental expenditure tables that accompany Chapters

III and IV of this volume, functional classifications have been varied freely from table to table, according to the objectives of the tables.

BENEFITS OF GOVERNMENTAL EXPENDITURE

Ineffective though the concept of "social benefit" may be as a standard of propriety for governmental functions, it is useful in analyzing the economic character of governmental expenditure. Without entering into the individualist-collectivist controversy, we may assume that some element of social benefit—some factor of "public interest"—underlies or can be read into every state function.

Social benefit and supplementary individual benefit

When a city employs firemen and maintains fire-fighting apparatus, its interest in saving Jim Smith's house or John Doe's factory after they have caught fire is only secondary; the social loss which results from destruction of property—anybody's property—is the primary concern. When a school district provides instruction for Smith's or Doe's children, the dollar-and-cents value these children derive—which their parents would probably purchase from private schools were a free public school system not provided—is subordinate to the social benefit of an educated population. When the federal government subsidizes the construction and operation of American ships, it is expending funds for the intangible values embodied in a national merchant marine, and is indifferent to the profits or values which some individuals incidentally derive.

It is almost impossible to conceive of a governmental function that does not benefit certain individuals as well as promote the general social welfare. Smith and Doe benefit individually from their city's expenditure on fire protection. Likewise they benefit individually from the education given to their children. Even federal defense expenditures carry a superimposed individual benefit—the extra profit earned by the manufacturers of defense materials. But always, it must be emphasized, these individual benefits are a by-product, supplementary to the basic social benefit. This is true even in the case of a governmental utility, such as a municipal light and

power system. Only the social purpose involved, the group benefit, justifies governmental expenditure upon any function.

Nonprofit nature of social benefit

Let us assume—though there are some who would argue the point—that the individual benefits inherent in some governmental activities could be provided, and adequately provided, by private enterprise operating on the profit incentive. Private detective agencies could offer some individuals and business concerns the protective services now supplied by the public police. For the children whose parents could pay the necessary tuition charges, private schools could more than supplant the public school system.

But there is no business profit to be derived from social benefit. No individual or syndicate could make a profit from the maintenance of military and naval armaments. No individual or consortium could have desire or reason to operate a judiciary system. Private schools are concerned with the education of their own pupils, not the community. And the manufacturer of railway equipment labors to create a market for his output and to profit from its sale; that the use of his equipment will promote transportation and commerce and contribute to the economic development of the nation is an incidental factor which he disregards. Private business enterprise cannot be counted upon to develop adequately a social benefit function which yields it no profit and which can never be more than incidental to the individual services it sells. The natural indifference of private business enterprise to the social benefit by-products of its activities is the reason why particular activities markedly "touched with a public interest" must be taken over by government.

Indivisibility of social benefit

When supplementary individual benefit accrues from some governmental activity, it can sometimes be divided into units, and be charged to the recipient. A municipal water system can make frontage or meter charges, courts and judicial officers can set fees for particular services, motor highway systems can be financed in

part by motor vehicle license charges and gasoline taxes. Indeed, as will be discussed later,¹ state and local fiscal systems have been severely criticized for their inadequate exploitation of special fees and charges for individual benefits.

But the primary social benefit resulting from any governmental function is indivisible. Expenditure on federal courts establishes federal law for the country, an incalculable joint service not only to the 130,000,000 Americans of today but also to the unnumbered millions of their descendants. In dispensing poor relief, the states and their subdivisions fulfill a collective obligation of society as a whole. New York City as a metropolis, rather than its individual residents, enjoys the benefits of the municipal dock system.

With benefits of governmental activity thus indivisible, it is folly to argue, as have many fiscal economists,² that taxes should be so levied as to apportion the costs of such functions among individuals according to their individual shares in the collective benefit. Supplementary individual benefits may be isolated, and fees and charges may assess some part or all of these by-product values to the beneficiaries. But the costs of the collective social benefit can be handled only as a collective obligation upon the community, to be apportioned among its members by whatever tax standard or standards enjoy current approbation.

ECONOMIC EFFECTS

In considering the effects of governmental activity upon the productive factors of a country or a community, we must take into consideration the methods of financing this activity—taxation and borrowing. Governments through their expenditures confer benefits of one sort or another upon the collective community and frequently upon particular economic and social groups within the community. Through taxation and borrowing, they deprive the same or other groups of purchasing power which might otherwise be devoted to private consumption or production.

More often in the past than at present, observations on the eco-

¹ See p. 611 of this volume

² See pp 283 ff of this volume

nomics of governmental activity were based exclusively upon one aspect—either on the spending, or on the taxing function. Mercantilist writers argued that the State in its operations gave employment to thousands who had no other employment, and provided many manufacturers with a market for their goods. Governmental expenditures were an unmixed blessing, contributing to industrial and commercial prosperity, injuring none, and benefiting all. Louis XVI of France, reproached for lavish outlays on his château while his people were starving, is said to have replied gravely and sincerely that that was the very reason for expending his funds with open hands—so that they would come into the possession of the people and ease their misery. Obviously, such views ignored the taxing activities of government.

English economists of the *laissez-faire* school, on the other hand, ignored the results of government expenditure, and studied the reduction of private purchasing power by taxation. According to their reasoning, funds which otherwise would have been devoted to production disappeared into government coffers, the initiative of entrepreneurs was stifled, and the economic progress of the country retarded.

Today we recognize that the obtaining and spending of government funds are closely interrelated as to their economic and social effects. The economics of the "New Deal" relief and recovery program and of defense or war procurement must be studied as much for their tax and borrowing concomitants as on the spending side. Economic results of the Agricultural Adjustment Act involved the processing taxes as well as the crop reduction payments. Our analysis of expenditure economics here necessarily overlaps the discussion of taxation and borrowing economics in Chapters X, XI, and XXVI.

Normal governmental expenditure and national income

Critics of the widening scope of governmental activity frequently frame their arguments on the assumption that the flow of funds to governmental units by their various revenue channels, and the subsequent disbursement of these funds in the course of governmental

functional activity, constitute a reduction of the national income. This view is false. While it is true that taxes and other governmental exactions do reduce the income available to particular individuals and business enterprises, governmental expenditure pours these funds back into the income stream. Offsetting the reduction of private income by taxation is the circumstance that every salary paid to a government employee is income just as fully as any salary paid by a business concern, and every payment of a government for materials or services constitutes gross income to the recipient exactly the same as payments for materials or services by business enterprises. Taxation and governmental expenditure constitute a detour for national income, not a blind alley.

It is an economic truism that expenditures for commodities and materials are more "reproductive" than expenditures for services, since the former maintain longer chains of production and distribution, each link of which is in itself income producing, than do service expenditures. Since a greater proportion of governmental expenditure than of private expenditure is for immaterial services, it is probably a fair conclusion that on the whole governmental expenditure is less immediately "reproductive"—less productive immediately of further elements of national income—than is private expenditure. But this is a short-term view. Many governmental expenditures, such as those for agricultural research, education, road building, and many other functions, provide a foundation for ultimate income production many times greater than the original outlay. And, as we shall see in a few pages when considering the federal "pump-priming" expenditures of 1933 through 1936, there is a possibility that under certain circumstances governmental expenditure may have exceptional immediate "reproductive" effects.

Normal governmental expenditure and the economic pattern

The "detour" analogy of governmental expenditure must not be interpreted to mean that such expenditure is a passive element in our national economy. On the contrary, any and every governmental expenditure has some effect upon the economic pattern of the country. In the creation of immaterial services, the talents hired

and the goods bought by governments are not those the taxpayers would have employed had they personally spent their tax payments. Tens of thousands of young men and women have been induced by the expansion of the public school system to train themselves as teachers; had there been no such expansion they would have entered other lines of endeavor. State and local governments buy concrete for highway construction; if the roads had never been built, the funds absorbed by highway taxes might instead have been spent for bicycles, clothes, or better housing. Without the federal government as its customer, the armaments industry could not exist. The redistributive effects of normal peacetime governmental expenditure tend to establish themselves as an unnoticed element in the economic equilibrium, but our acceptance of them in the economic order at any moment must not blind us to their tremendous weight in establishing that order.

Some writers have argued that "transfer" expenditures, such as veterans' bonus, debt service, or poor relief payments, where a government takes funds from *A* and pays them over to *B* without making any related demands upon *B*, do not change the structure of consumption and production. The funds in question are ultimately spent by a different set of individuals, but they are spent for private consumption or investment purposes, and the economic pattern remains unchanged. This argument ignores the circumstance that the beneficiaries of a "transfer" expenditure and the taxpayers who provide the funds usually belong to widely different economic groups, so that their utilization of the funds would vary. AAA payments to farmers during 1935, for example, came from processing taxes eventually borne by the consumers of agricultural commodities; the beneficiaries unquestionably employed their funds for quite different purposes than the bearers of the tax burden. While it lasted, the AAA program probably checked purchases of the various items which urban consumers buy and stimulated buying of agricultural machinery and the business of the mail-order houses which supply the farm population. Similarly, the people who receive poor relief spend their allowances more on necessities and less on luxuries than do the taxpayers whose expenditures are re-

duced to support the poor relief. Retirement of governmental debt issues held by banks and insurance companies from funds drawn from business and individual taxpayers markedly transforms the uses that would be made of these funds. "Transfer" expenditures, though they do not contribute to the "burden" of government, generally are as potent as other governmental expenditures in transforming the economic structure of the country.

When a government finances its expenditures by borrowing, it may redistribute consumption and production not alone among economic groups and industries but also over periods of time. If the bonds that finance the expenditure are purchased by individuals or institutions that would otherwise have placed accumulated investment funds in other securities, no temporal transposition of purchasing power and productive activity is accomplished; government expenditures are merely substituted for individual or business investment outlays during the period in question. But if the government's bonds are sold to commercial banks that create the credit which they employ for such purchase, the government obtains and brings into the market a completely new element of purchasing power. Men and productive forces that would otherwise be idle are employed. In subsequent years, as the resulting debt is retired, taxpayers' funds are diverted from consumptive or productive application, and are used to reduce the bank credit which supported the government's initial borrowing. Thus purchasing power and a related element of productive activity are shifted forward from a wide range of later years and are concentrated in an earlier period. To the extent that commercial banks bought state and local bonds during the 1920's—and some part of the state and local issues of that decade found their way into bank portfolios—the highway, institutional, and other constructional governmental expenditures of that period caused just such temporal shifting of economic activity as has been described.

Financial effects of normal governmental expenditure

Normal public expenditures, financed by taxation and a moderate amount of borrowing, have little effect on the volume of credit and

currency, or on the general price level. Purchasing power diverted from private hands by tax payments and bond issues is returned to the market through governmental expenditures. Governmental activities absorb labor and material which otherwise might have gone into private production, but this is counterbalanced by the restriction of private purchases through taxation and borrowing. Just as the shift of purchasing power from private hands to governmental units stimulates some industries and represses others, so it probably raises somewhat the prices of materials and skills used by the government, and weakens other prices.

If federal investments in the initial capital of the farm credit institutions, the Reconstruction Finance Corporation, the Home Loan banks, the Home Owners Loan Corporation, and the Federal Deposit Insurance Corporation be considered expenditures, it might be argued that these outlays have had far-reaching effects upon the pattern of American long-term and short-term credit. The long-run financial consequences of these investments, however, should not be viewed as results of the particular expenditure transactions involved; rather they flow from the financial functions made possible by the federal government's investments. It is the Home Loan banks as institutions for rediscounting mortgages, and not the federal government's investment of \$125,000,000 in the stock of these banks, that makes savings bank and insurance company holdings of qualified home mortgages a liquid asset.

Fostering particular industries

Even in normal times, some industries exist only or mainly by reason of governmental expenditure. The armament industry has been indicated as such a one. But, in addition to maintaining occasional firms or lines of activity by "normal" purchases, a government may, as a public function—for some particular social benefit—subsidize an industry. Examples in American fiscal history are the subsidies to aviation concealed in the air-mail payments, the sugar bounty provided by the McKinley Tariff, and the shipbuilding and shipping subsidies of the Shipping Act of 1936. Local governments sometimes raise and pay a flat sum, or make a gift of

suitable buildings, to induce a manufacturing enterprise to establish itself in the community. State or local bounties to farmers for timber planting on nonarable lands have been proposed.

Social benefit can be imputed to a subsidy that enables an industry essential, or believed to be essential, to the national welfare to remain on a profit basis during a period of development or while it charges the subprofit prices established by foreign competition. In wartime, it was argued in support of the subsidies embodied in the 1936 Shipping Act, a merchant marine is a prime national asset both as a commercial carrier and as a fleet auxiliary. High operating costs because of strict safety and labor standards, and subsidies which foreign shipping lines currently receive from their governments, make it impossible for American lines to meet the charges set by their foreign competitors and cover their costs. So the federal government should cover the losses of the American lines plus a return on the capital invested, and count the existence of an American merchant marine as return on its payment. Similarly, the air-mail subsidies are intended to enable the American air lines to maintain themselves while they stimulate air traffic by charging below-cost rates.

Whether federal subsidies of this character are worth what they cost is an open question. Argument and evidence on both sides are ample and inconclusive. But the case on local bounties to encourage settlement of manufacturing enterprises is clear. They are unwarranted. The gain of the community which thus attracts an enterprise is offset by the loss of whatever community would otherwise have had it. Suicidal rivalry in such bounty granting is a logical outcome of the practice. The country has not benefited, and the taxpayers of one set of communities have bought the distress of another. Worse yet, the practice has encouraged the development of migratory parasitic firms which stay long enough to collect their bounty, and then move on to some other "sucker" community.

Effects of federal war and defense expenditure

War expenditures, and such exceptional emergency expenditures as the defense procurement program initiated by the federal gov-

ernment in 1940, have special economic and financial repercussions. In part this may be attributed to their tremendous magnitude, in part to the abruptness with which they are imposed upon the national economic structure.

If a war or defense expenditure program is initiated at a time when there is an excess of productive capacity and unemployed personnel, it can be continued for a while simultaneously with current civil production and consumption without distorting the pattern of the latter. The earlier stages of war or defense procurement may be adequately covered by the slack of industrial capacity and unemployed personnel. Sale of federal debt issues to banks provides the government with purchasing power to command these unemployed resources and workers without in any way reducing civil purchasing power. The civil economic system will not remain unaffected, however, since the added production and employment produced by the government's war or defense procurement are bound to increase the flow of civil consumption and business purchasing power. Civil production tends to expand and encroaches upon the slack of excess capacity which the government is endeavoring to absorb in its procurement program. This was the situation of the federal defense expenditures during 1940.

When an expanding war or defense expenditure program financed by borrowing impinges upon the economic system operating at full productive capacity, as occurred in 1917 and again in 1941, the pattern of civil economic life must be altered radically to conform to the superior demands of the national emergency. With industrial equipment and personnel operating at full capacity, increased governmental demands can be met only by diverting equipment and personnel from civil production—at the very time when streams of consumer purchasing power and business demand based upon this consumer demand are flowing upon the market with re-enforced volume. If methods of quarantining or absorbing the expanding stream of consumer and business purchasing power are not devised, the federal government and the civil economic system must enter into competitive bidding for available raw materials, production facilities and personnel. Ironically, the government through its

credit-financed disbursements continually provides the civil population with increased purchasing power wherewith to engage in this market competition. Of course the government must emerge victorious in this bidding match, but only at the cost of forcing many prices to stratospheric heights, multiplying the expense of its war or defense program, and instigating an inflationary boom that may have disastrous consequences.

There are two alternatives to such rampant *laissez-faire*.³ One is to quarantine as large a fraction of consumer and civil business purchasing power as is necessary by "priorities" and rationing, buttressed by price control. The purchasing power so quarantined may find an outlet in the purchase of government securities by individuals and business houses, or it may lie latent in "dead" bank deposit until the emergency is past and the controls loosened. The major defect of this procedure is the difficulty of devising controls effective against the intensifying pressure of cumulating consumer and business purchasing power; during a war period the sense of national crisis may maintain the operating efficiency of these controls, but such popular support cannot be marshaled during a period of defense procurement or upon the conclusion of war hostilities. Absorption of consumer and business purchasing power, the second method of preserving the market for federal war or defense purchases, would seem to be the more effective technique. Such absorption can be accomplished by special elements of the tax system⁴ and by special techniques of borrowing.⁵

Whether governmental war or defense spending operates in an untrammelled competitive market, or whether civil consumption and business purchasing power is quarantined or absorbed, such multi-billion dollar expenditures of the government cannot help but reshape the economic structure of the nation. Industries contributing to the war or defense program expand to commanding position. Other enterprises either barely hold their own, or shrink as deterio-

³ See Horst Mendershausen, *The Economics of War* (Prentice-Hall, New York, 1940), Pt. II, Paul W. Ellis and William J. Shultz, "Fundamental Tax and Debt Policies," in The Conference Board, *Essential Facts for Fiscal Policy* (the Board, New York, 1941), pp. 10-16

⁴ Discussed on p. 276 of this volume

⁵ Discussed on p. 654 of this volume.

ration of equipment and diversion of personnel make their effects felt. Personnel skills are altered. Patterns of civil consumption and habits of personal expenditure and saving are all violently changed.

Nor are the effects of multi-billion dollar war or defense expenditure limited to the period of the military emergency. With the passing of the emergency, the country finds itself saddled with productive equipment and personnel fitted only to produce materials not needed in a postwar world. A new economic dislocation, more abrupt and hence more severe than that which accompanied development of the war or defense program, is inevitable. It is just as truly a direct consequence of the war or defense expenditures as the original readjustment, and anticipatory preparation for softening the effects of the dislocation is a necessary element of war or defense planning.⁶

Exceptional war or defense expenditures cannot by themselves directly influence the capital market. But the means of financing them may. Federal taxes and borrowings during 1917 and 1918 absorbed so large a fraction of private purchasing power, which would normally have found its way to the investment market, that private enterprises could obtain new capital only at exorbitant rates. This was a desirable incident of the war finance program, since it tended to discourage expansion of civil industries that might have interfered with the government's war procurement efforts. But special provision had to be made if enterprises essential to war procurement were not to be crippled by their inability to obtain long-term funds, and if the security portfolios of commercial and savings banks were not to be "frozen." To guard against these eventualities, the War Finance Corporation was established in April 1918, its half-billion-dollar capital provided by the federal Treasury, to supply the capital needs of essential enterprise and to rediscount the security holdings of banks. Any program of war or defense finance that involves "absorption" of civil purchasing and invest-

⁶ See William J. Shultz, "Defense Finance and Postwar Objectives," in The Conference Board, *op cit*, pp 118-123. On February 7, 1941, President Roosevelt announced to the press that a "reservoir of postwar public works projects" was being planned and would be immediately authorized to take up the slack of defense production that will develop as soon as the war emergency passes.

ment power must carry provision for some "crutch" for the capital market.

Economics of "pump-priming" expenditure

From 1933 through 1936, the Roosevelt administration sought to utilize the indirect economic effects of governmental expenditure as an instrument for promoting recovery from business depression. According to the "pump-priming" theory adopted by the administration, taxpayer purchasing power for a score or more years ahead could be shifted forward by federal borrowing and applied by the government in the current emergency, where it would fill the temporary vacuum in spending activity resulting from the hoarding of "dormant" capital. Application of this forward-shifted purchasing power would be made through a public works program. It was believed that every dollar spent by the federal government for labor and materials would start a chain of private expenditure as the initial recipients spent such funds for further purchases of materials and services. In the course of successive transactions, these resultant private purchasing chains would eventually taper off and be dissipated through saving and debt repayment, but in their collective total they would constitute an impressive volume of added expenditure. If this induced "secondary" expenditure reached sufficient volume to tax existing productive capacity, new private investment would be undertaken. And this new investment would be the factor that would pull the national economy out of depression and into recovery.⁷ "Pump-priming" expenditure by the federal government would perform the double function of converting depression into recovery and providing the country with a valuable crop of public works.

Appropriating billions of dollars for public works proved to be easier than instituting soundly conceived projects. When the Roosevelt administration saw its public works program lagging, it turned to a second method of injecting purchasing power into business channels. The billions that could not be laid out on public works

⁷ See John H. Williams, "Deficit Spending," *Papers and Proceedings of the 53rd American Economic Association Meeting*, 1940, p. 56

were expended in relief grants and "make-work" relief employment. A larger proportion of the federal funds went to individual recipients, a smaller proportion to industry for materials. These relief payments were spent on food, rent, clothing, and other necessities, and so they also moved into business channels and started chains of purchase, production, and employment without, however, producing any lasting public works. Paying veterans' bonuses, or showering the same billions of dollars haphazardly over the country by airplanes would have accomplished an equivalent stimulation of recovery, but relief payments had the added advantage of easing the sufferings of the classes hardest hit by the depression.

For years bitter controversy raged over the Roosevelt "pump-priming" expenditure program. By now the issues are sufficiently clarified to permit the statement of certain broad conclusions about "recovery" governmental expenditure.⁸ *First*, there can be no question but that governmental expenditure not offset by concomitant taxation introduces an additional element of purchasing power into the economic system. *Second*, this additional purchasing power is "reproductive," and may induce an even greater volume of "secondary" private expenditure; if the induced "secondary" private expenditure is large, a further "tertiary" private investment expenditure may be stimulated, provided that there is not too great an excess of unused productive capacity, and also provided that the business community looks to the future with some degree of confidence and foresees the possibility of future profit on the new investment. *Third*, for so long as the business world distrusts governmental deficit financing, large-scale use of that technique of promoting recovery may sap business confidence; the resulting check to business investment expenditure will partly, and may completely, offset the recovery-stimulating effects of the "pump-priming" expenditure. *Fourth*, if some balance of stimulative effect in "pump-priming" expenditure is assumed in spite of the third consideration noted above, such expenditure must be of sufficient magnitude to

⁸ See Arthur E. Burns and Donald S. Watson, *Government Spending and Economic Expansion* (American Council on Public Affairs, Washington, 1940), Alvin H. Hansen, *Fiscal Policy and Business Cycles* (Norton & Co., New York, 1941), Henry H. Villard, *Deficit Spending and the National Income* (Tarrar & Rinehart, New York, 1941)

carry the national economy to and past the point of cyclical regeneration; otherwise it merely serves as palliative and not as "recovery" expenditure.

The "pump-priming" spending of the federal government from 1933 through 1936 failed of its goal of translating depression into a recovery that could continue upon its own momentum. The idea of the country's "spending its way out of depression" only heightened the mistrust of business men already hostile to the Roosevelt administration and, together with other elements of the New Deal program, discouraged investment expenditure upon private business projects. And, from the vantage point of hindsight, we can realize now that, tremendous as were the "pump-priming" expenditures of the federal government from 1933 through 1936, they were insufficient to counterbalance the shrinkage of private expenditure in the same period, as is evident from the data presented in Table 1; little or no "tertiary" private investment expenditure was induced. From 1932 through 1935, federal "investment" expenditures would have had to be in the neighborhood of \$10,000,000,000 a year to have compensated adequately the low level of private investment expenditures in those years. Such recovery as was induced by these expenditures was only palliative; it never became self-generating. And when the "pump-priming" expenditures were suddenly reduced in 1937, this reduction was a significant factor in the new recession that developed in that year.

Smoothing the business cycle

Quite distinct from "pump-priming" or "recovery" programs of governmental expenditure is the proposal for so scheduling a part of the *ordinary* expenditures of American governments that these expenditures will tend to soften rather than accentuate cyclical business fluctuations.

Governments have a wide latitude of choice in building new roads, new public buildings, new irrigation projects—they may decide whether to build them immediately or a few years hence. Prior to the 1930's, American governments chose to undertake their capital projects in years of prosperity, when public confidence was high

and electorates and legislatures were optimistic. Public borrowing and building slackened in years of recession, and the policy was "go slow until the storm blows over." Obviously, such a policy of government construction accentuated the swing of the business cycle.

Instead of augmenting the violence of cyclical business trends, governmental construction programs can and should be used as partial counterweights to general business fluctuations, provided that they are based on foresight and preplanning.⁹ Overexpansion of

TABLE 1

FEDERAL INVESTMENT EXPENDITURE IN RELATION
TO PRIVATE INVESTMENT EXPENDITURE, 1927-1938

(Amounts in billions)

| Year | Net National Income | Investment Expenditure | | | | Year | Net National Income | Investment Expenditure | | | |
|------|---------------------------|---------------------------|--------|---------|-------|------|---------------------------|---------------------------|--------|---------|-------|
| | | Private | | Federal | | | | Private | | Federal | |
| | | a | b | a | b | | | a | b | a | b |
| 1927 | \$75 4 | \$15 8 | | \$ 3 | | 1933 | \$40 0 | \$ 1 0 | \$ 1 2 | \$1 8 | \$1 8 |
| 1928 | 78 6 | 15.2 | | 6 | | 1934 | 49 3 | 2 7 | 2 2 | 1 8 | 3 3 |
| 1929 | 81 9 | 16 7 | | 7 | | 1935 | 55 1 | 5 6 | 7 2 | 2 7 | 3 0 |
| 1930 | 72 0 | 13 2 | \$11 2 | 1 2 | \$.3 | 1936 | 64 7 | 10 1 | 10 2 | 3 5 | 3 9 |
| 1931 | 56 7 | 6 8 | 6 7 | 2 9 | 1 8 | 1937 | 71 9 | 12 2 | 13 4 | 1 9 | 8 |
| 1932 | 41 0 | 1 8 | 7 | 3 1 | 1 8 | 1938 | 63 4 | 9 2 | 11 8 | 1 7 | 2 4 |

a Based on statement submitted to TNEC by Lauchlin Currie on May 16, 1939

b Based on figures from Henry H. Villard, *Deficit Spending and the National Income* (Farrar & Rinehart, N. Y., 1941), p. 285

business activity during boom years can be discouraged by curbing governmental outlays—at least, a reduction of public works expenditure in boom times will prevent such expenditure from contributing to the boom. Intensified public borrowing and building on the advent of recession will ease, if not check, the recession; it will

⁹ The most comprehensive analysis of the "counterweight" proposal is Arthur D. Gayer, *Public Works in Prosperity and Depression* (National Bureau of Economic Research, New York, 1935); see also Temporary National Economic Committee, *Government Purchasing—An Economic Commentary* (Monograph No. 19, 1940)

credit hamstrung many local and some state governments. Others were forced to devote available resources to emergency relief projects of the "make-work" variety. Eventually the idea of a cyclical "counterweight" planning of public works was absorbed in the development of the emergency "pump-priming" program under the influence of federal Public Works Administration grants. With no reappearance of economic "normalcy" during the 1930's, there was no further opportunity for practical reconsideration of "counterweight" expenditure. Development of the "defense" emergency in 1940 meant a further postponement of all "counterweight" projects.

The "counterweight" proposal must be distinguished from "recovery" or "relief" projects—the abrupt creation of construction activities out of thin air to force purchasing power willy-nilly into the business markets or to cloak a dole under the guise of public works. Quite as important as the expansion of public works during business recession is the restrictive phase of a "counterweight" program during a boom period.

For effective operation, such a program demands intelligent and careful foreplanning of public works. Construction projects must be divided into two classes—those immediately necessary and those which can be postponed or advanced without great injury. The former can have no place in the foreplanning. But the adjustable projects should be prepared in advance with full designs and working plans filed away until actual physical construction is begun. Only in conjunction with such advance preparation is the proposal feasible.

Criticism has been heaped upon the proposal on various grounds—it is argued that a "counterweight" program will mean more public works and hence a greater cost of government, that preplanned and "preserved" public works are reduced to impracticality by changing circumstances, and that forecasts of cyclical trends cannot be sufficiently accurate to permit the correlation of a broad construction program. Of these objections, only the second may have some weight. The first criticism, that "counterweight" planning of public works increases the cost of government, overlooks the consideration that a true "counterweight" program, as distinguished

from emergency "pump-priming" expenditure, merely redistributes the undertaking of public works over a cyclical interval of time and does not add to the total. In answer to the third criticism, it may be argued that even a loose inverse correlation of public works expenditure and business trends will be beneficial. The second criticism—that plans for postponed projects may be outdated when the times comes to apply them—will be valid only if no effort is made to keep such plans revised and currently applicable for such time as they are "on the shelf"; and periodic refreshing of all "shelved" project plans is part of the technique of "counterweight" procedure.

Quite apart from the "counterweight" value of the cyclical pre-planning of public works, governments have everything to gain and little, if anything, to lose by concentrating their construction projects in periods of slackening business activity and avoiding such expenditure during boom times. Governments which construct public works in depression periods gain the advantage of falling prices and wages. Since interest rates also tend to fall, governments can market their construction bond issues at exceptionally favorable interest rates. Boom-time construction of public works, on the contrary, involves high costs and high interest rates.

SOCIAL EFFECTS

If a government limited its functions to the provision of a judiciary structure and the protection of life and property, and financed its expenditures by taxes resting primarily upon those individuals and income classes which derived supplementary individual benefit from these functions, the pre-existing distribution of wealth and income would be undisturbed. Suppose, however, that this government obtained its income from consumption excises. The poorest classes, which derived little benefit from the government's expenditures, would pay the major part of the revenue. Obviously, such an arrangement would augment any pre-existing inequality of income—it would take from the poor and give to the rich. Finally, the government might devote a major proportion of its expenditures to social welfare functions whose supplementary individual benefits went to the poorer elements of the population, and obtain its rev-

enues from sharply progressive personal taxes bearing most heavily on the income, and even on the wealth, of the richest elements of the population. Such governmental activity would result in social equalization—it would take from the rich and give to the poor.

Both American and foreign nineteenth-century fiscal policies generally had the effect of further accentuating current inequality in the distribution of wealth and income. Federal, state, and local governmental functions assisted property and business, and the owners of property and business. And, while most of the taxes likewise came from these two classes, a not inconsiderable revenue was derived from consumption levies borne by the poor and propertyless as well as by their more fortunate neighbors.

For a half century at least, the tendency has been in the opposite direction. Expansion of the educational program, the growing scope of state and local social welfare activity, the recent plunge into a program of social insurance—all are aspects of State action which, over and above such elements of "social benefit" as may be read into them, contribute far more to the welfare of the poor than to the rich. Meanwhile the growing emphasis upon income, death, and business taxation is shifting a larger portion of the burden of government upon the rich.¹²

Nowhere in orthodox fiscal literature is there the advocacy of an "equalization" motive for governmental activity. If the subject is mentioned at all, the suggestion is sternly reproofed. But the phrase, "Soaking the rich," used in connection with income and death tax schedules, indicates that the idea is present in some legislative minds. While this motive may not heretofore have been an active factor in public expenditure and tax legislation, the student of Public Finance cannot overlook the growing "equalizing" effect of fiscal developments.

¹² See p 292 of this volume.

CHAPTER III

American Governmental Expenditure

How much do our American governments—the federal government, the 48 state governments, and the 175,000 or more local units¹—spend each year? To what extent and why are their expenditures increasing? For what purposes do they expend the money which they obtain from the American people by taxing, by borrowing, and by other means which will be considered later?

These questions are primarily factual. The answers are to be found in the welter of statistical data collected and issued by thousands of governmental departments, and subsequently organized and summarized by various research organizations.²

¹ As of 1934, there were 3,053 counties and parishes, 8,580 special districts, 16,366 incorporated cities and villages, 20,262 towns and townships, and 127,108 school districts. William Anderson, *The Units of Government in the United States* (Public Administration Service, Publication No. 42, 1934), p. 1.

² Federal government expenditures, classified by function and department, are presented in the annual Reports of the Secretary of the Treasury and in the annual Budget Reports.

State statistics must be tracked down state by state in the annual or biennial reports of finance departments, state tax commissions, comptrollers, budget bureaus, and other departments. In some states a complete presentation, with good functional classifications, may appear in the report of some single department. More often, however, the figures are scattered through the reports of various independent departments or bureaus. From 1917 to 1931, the Federal Bureau of the Census collected statistics on state expenditures and published them in its "Financial Statistics of States" series. Unfortunately the series was discontinued for several years during the 1930's because of insufficient appropriations, but it has recently been revived.

States which require their local units to report financial operations to some central agency publish consolidated statements of the expenditures of these units. But the states which make such requirement of all their local units are in a minority. To obtain full statistics of local fiscal operations, thousands of reports would have to be obtained from various classes of local governments in the several states. And once received, they would be practically useless for the preparation of a consolidated statement, since there would be no uniformity in their basis of reporting or their classifications. Annual estimates of the total of local expenditures, with some attempt at functional classification, are made by the National Industrial Conference Board. The federal Bureau of the Census made and published a classified survey of local expenditures in 1902, in 1912, 1922, and 1932 it issued partial statistics on the subject. Detailed figures on local highway expenditures are published annually by the federal Bureau of Public Roads, statistics on local school expenditures are issued biennially by the federal Office of Education, and annual figures on various classes of state and local social expenditures are compiled by the Social Security Board.

GROWTH

Statistics on combined federal, state, and local expenditures in the United States may be had only for occasional years back to 1890. Even these limited data show the consistent increase in such expenditures during the half century. As indicated in Table 2, this growth has occurred not only in absolute amount, but also as measured against population and national income. Absolute amounts more than tripled between 1890 and 1913, tripled again between 1913 and 1923, and doubled again by 1937; with the federal armament program developing in 1941 at accelerating pace, another doubling of total American governmental expenditures is in near prospect. Per capita expenditures increased tenfold between 1890 and 1940, or sevenfold if price changes are taken into account. Prior to the initiation of the defense program, over one-quarter of our national income was channeled through government payment; continued expansion of the defense program, or its evolution into a war pro-

TABLE 2
AMERICAN GOVERNMENTAL EXPENDITURE, SELECTED
YEARS 1890-1940

| Year | Amounts (in millions) | Amounts (in millions) in "1926" Dollars ¹ | Per Capita | Per Capita in "1926" Dollars ¹ | Ratio to National Income |
|---------------|-----------------------------|---|---------------|---|-----------------------------------|
| 1890 | \$ 893 | \$ 1,589 | \$ 14 16 | \$ 25 20 | 7 1 |
| 1903 | 1,636 | 2,745 | 20 20 | 33 89 | 7 0 |
| 1913 | 2,691 | 3,855 | 27 88 | 39 94 | 7 3 |
| 1919 | 21,156 | 15,264 | 201 48 | 145 37 | 33 3 |
| 1923 | 8,309 | 8,259 | 74 50 | 74 06 | 11 6 |
| 1929 | 10,936 | 11,512 | 89 99 | 94 43 | 12 6 |
| 1933 | 10,635 | 16,261 | 84 69 | 128 51 | 25 1 |
| 1936. | 16,350 | 20,235 | 127 68 | 158 02 | 26 1 |
| 1939 | 17,856 | 23,160 | 136 43 | 176 95 | 25 2 |
| 1940 | 18,745 | 23,849 | 142 06 | 180 74 | 24 7 |

¹ Calculated by dividing the figure for each year's expenditures by the corresponding index number of the United States Bureau of Labor Statistics wholesale price index

Derived from The Conference Board, *The Economic Almanac for 1941-42* (the Board, New York, 1941), pp 358-359.

gram, could readily carry the proportion up to one-half. Government is today America's biggest field of economic activity, outranking production, agriculture, or distribution of goods and services.

Effect of changing price levels

As commodity prices and salary levels increase, each dollar appropriated for governmental expenditure buys less and less. To maintain activities at the level of prior years, governments must increase their monetary appropriations. If they buy the same amounts of materials, and employ the same personnel, they must pay higher prices for their materials and higher salaries to their officials and employees. Contrariwise, when the general price level is declining, a government may show a reduction in its monetary disbursements and still buy the same quantity and quality of materials, and use the services of the same grades of officials and employees. A mild rise in prices added 20 per cent to the apparent cost of government between the mid-1890's and 1913. Price developments during the next seven years more than doubled governmental costs. After a precipitous drop in 1920, prices remained fairly stable through 1929. Another sharp price drop—nearly one-third—occurring during the next four years, was reflected in governmental costs by salary cuts and lower cost of materials. Since March 1933 the persistent trend of prices has been upward, with a corresponding increase in cost burdens for all governmental units.

Statistically, the effect of changing price levels upon governmental costs can be discounted by stating expenditures in terms of the purchasing power of some "base year" dollar. In Table 2 total and per capita expenditures are stated in "1926" dollars. Note that the absolute increase of total governmental expenditures from 1890 to 1929 was nearly 1270 per cent, whereas the "true" increase was only 708 per cent. On the other hand, absolute expenditures increased only 4.3 per cent between 1929 and 1933, but with falling prices this represented a "true" increase of over 50 per cent.

But marked changes in the general price level do not affect alone the monetary expression of governmental activities. Indirectly, they lead in the long run to increased and expanded public expenditure.

As prices rise, the maintenance of existing governmental activities grows more expensive because of the mounting costs of materials and services. Simultaneously, the rising price level operates to increase land values, raise income levels, and in other ways broaden the bases of the taxes which provide the funds for governmental activities. With increasing revenues available, there is little hesitancy in voting larger appropriations to maintain the current level of governmental activity at its higher cost. A subsequent decline in the price level rarely carries governmental expenditure back to its previous figure. Governmental wages and other payments are among the most "sticky" of price factors, particularly on price downswings, and they resist the general movement. Should the fall in governmental costs be more rapid than the shrinkage in tax bases, and an excess of "true" revenue result, politicians prefer to spend such a "surplus" on enlargement of governmental functions rather than to reduce tax rates or to abolish special taxes. If revenues shrink more than governmental costs, the easy way out is to meet the resulting deficits by temporary borrowing or higher tax rates.

Effect of business cycle developments

In the past, broad cyclical fluctuations of business activity have operated as a one-way ladder for governmental expenditure. Legislators among others are infected with the general optimism that accompanies boom times, and thoughts of governmental progress and expansion capture their imaginations. State assemblies, county and town boards, city and village councils vote new functions and enlarge existing ones. Taxpayers offer little objection, because the combination of prosperity, rising values, and increasing incomes reduces the burden of pre-existing taxes.

When recession comes, the new functions are found to be "frozen" into the system. There may be overtures to "economy," but rarely do they restore the old level of governmental costs. Moreover, it is now accepted that government must undertake the relief functions associated with business recession. These "relief" functions may carry the recession cost of government above even the prior prog-

perity level, as occurred during the early 1930's. And then, as recent experience has shown, these depression "relief" functions freeze in turn into the governmental structure, and are continued after the pressing need for them has passed.

Effect of national growth

For a quarter century after 1890, the United States expanded internally. New counties, school districts, road districts, drainage districts, villages, towns, and cities were constantly being organized. Governmental functions were provided over a wider area and to a greater population, and, perforce, governmental expenditures increased. Although this "expansionist" growth of governmental activity was most marked in the case of state and local units, the federal government also had some share in the development. What part of the \$1,500,000,000 "true" increase in state and local expenditures between 1890 and 1913 is attributable to national "expansion," and what part to other factors, cannot be determined, but certainly "expansion" must be rated a major factor in this period.

Higher per capita cost of city government as compared with rural government is not accounted for exclusively by a surplus of service functions which cities provide for their residents. Increasing density of urban and suburban population necessitates special "remedial" public functions. City crowding breeds problems of sanitation, crime, social welfare, and traffic which are less pressing in the countryside. Much of the cost of city government results from "remedial" functions that ward off the social disadvantages of urban growth rather than confer social benefits.

But density of population has its governmental economies as well as its extra costs. A legislature for a population of millions involves little more cost than one for a population of thousands. It may cost no more to construct a motor highway at a low per capita cost through a densely populated state than through a sparsely settled region. Many governmental services such as forest-fire prevention are performed at relatively constant cost, irrespective of the number of individuals benefited. Furthermore, economies of mass production are applicable to some governmental functions. In the purchase

of standardized supplies, New York City can effect economies impossible to a hundred small cities having the same aggregate population. Per capita expenditures are about the same in cities of 300,000 and 30,000 population although the former must provide more "remedial" functions. Lower unit cost for many standard governmental functions seems to be the explanation of the phenomenon. With growth of city size, a decrease in unit cost of government tends to offset an increase in per capita functional activity.

Finally, there is the factor of economic growth. An industrial civilization calls upon its governmental agencies for many services not required by an agricultural civilization. Industry having produced the automobile, construction and maintenance of an improved highway system required the expenditure of billions of dollars. Metropolises, developed by commerce and industry, magnified the ramifications and possibilities of social delinquency, and state and local governments had to develop a new penology and new agencies of social welfare to meet the situation. Large-scale labor difficulties grew up with large-scale industry, and government had to create and supervise ameliorative projects—workers' compensation, public employment agencies, unemployment insurance, the National Labor Relations Board, and other labor supervisory bodies. Competition and financial malpractices of large-scale enterprises established the need for the Federal Trade Commission, the Securities Exchange Commission, the Interstate Commerce Commission, and the various state railroad and public utility commissions.

Economic progress and increasing density of population involve higher governmental costs, but they also result in a more than proportionate concentration of wealth and income. Were the scope of governmental activity in the United States to remain the same while economic and population growth continued apace, the burden of governmental activity, as measured by income or wealth, would probably diminish.

Expansion of public functions

By the progressive additions of new State functions, American governmental expenditure has expanded over and above the in-

crease compelled by national growth and progress. Less than a century ago, Herbert Spencer described the role of the State as that of "passive policeman"—a protector of the peace, a guardian of domestic law and order. But today, American governmental activities range from the construction and operation of the Panama Canal, a thousand miles from continental United States, to the replanting of deforested hillsides and the provision of social insurance. "New Deal" legislation has in the past decade committed the federal government and the states to many functions which were originally denounced, and in some supporting quarters freely proclaimed, as "socialistic," but which now are inextricably a part of the American economic system.

We have already noted that economic progress alone forces many new functions upon government. But this compulsory expansion of the sphere of government has been supplemented or accompanied by a voluntary enlargement of the scope of public activity. The public purse has been opened to assist the nation's unfortunate and the nation's unfit—the unemployed, the depression-ridden farmers, widows and orphans, the aged poor, the halt, the lame, the blind, and the insane. So also, the federal government and to a lesser degree the states have added to their costs of government by expanding and strengthening their controls over various aspects of business activity. In part these new social expenditures and business controls may be viewed as called forth by the economic evolution of the nation; but in part they constitute new responsibilities undertaken by American governments in response to changing popular views upon the scope of governmental functions.

"Pressure group" technique, developed to a high degree of efficiency, is a potent weapon in overcoming the inertia of governments against initiating new functions. Disinterested humanitarians and interested economic groups have learned to hire experts in the art of persuading and coercing legislators to vote new governmental activities, sometimes meritorious, sometimes difficult to justify by impartial standards. So, during the 1920's, more and better schools were built and the school curriculum was launched toward new horizons, improved methods of garbage disposal were provided,

systems of mothers' pensions were voted, state hail insurance was developed, and funds were provided to combat the corn borer and the boll weevil. And during the 1930's, cities which by any manner of means could raise the funds provided home relief for their unemployed and their unemployables, states increased their social welfare appropriations, and the federal government paid out billions of dollars in farm aid and supported a federal theater.

Effect of wars and national emergencies

War, as a national emergency, is the concern and the financial responsibility of the federal government. Fortunately, during the century and a half of its existence, the United States has engaged in but six. Three of these—the Civil War, World War I and World War II—made heavy demands upon the nation and the federal government. The "defense" program initiated in 1940, itself more costly than any prior war effort, was but a prelude to the greater national sacrifice demanded by participation in World War II.

Immediate costs of prosecuting hostilities are only a fraction of the total cost of war to the federal government. A war debt of substantial magnitude may take generations to retire, and during that time interest payments may cumulate to more than the original capital sum of the debt. As the years pass, pensions and other forms of special compensation to those who performed military service are increased through political pressure. War claim settlements drag over decades. The Civil War, not yet completely paid for, since many pensioners are still living, has to date cost the federal government \$11,400,000,000. The present incomplete bill for the Spanish War is over \$3,000,000,000. As of 1934 World War I costs had already mounted to \$42,000,000,000 with the final cost certain to be many billion dollars higher.

As a consequence of these aftercosts of war, federal expenditures advanced to a new, lasting, high level after each of its wars. Partly responsible for each of these increases in federal governmental costs has been the price inflation associated with each war. But in each instance the greater part of the increase must be attributed to expenditures directly consequent upon the war—liquidation of supple-

mentary war agencies, interest on the war debt, retirement of the war debt, pensions and other forms of veterans' aid, and maintenance of an enlarged military and naval establishment. Most striking was the effect of World War I on federal expenditures. During the decade preceding America's entry into the war, federal expenditures averaged under \$700,000,000 annually, during the decade following the end of the war, the annual average was nearly \$4,000,000,000. Indirectly, a war may also affect state and local expenditure. During the period of America's participation in World War I, federal demands for materials, services, and credit compelled state and local governments to postpone all but the absolutely indispensable programs of capital construction. When the war was over, the state and local governments found their construction programs in arrears. In 1919 they catapulted themselves into an orgy of capital outlay at a time when they had to pay the highest rates for the funds they borrowed. Roads, schools, public buildings delayed by the war were constructed, the check to civic progress was overcome. But, as a result of this blind drive to catch up with postponed construction projects, state and local governments have ever since had to carry an excessive burden of interest and debt retirement payments.

State governments not infrequently make direct contributions to the war program of the federal government, by raising and equipping regiments of the National Guard subsequently incorporated in the federal military forces. They may vote special compensation to their own veterans after the war. Though such state military expenditures are dwarfed by comparison with the federal war budget, they must not be ignored in any general survey of war costs.

"Emergency" expenditures for recovery and relief, inaugurated between 1932 and 1935, likewise left a lasting impress on the level of federal expenditures. A host of new "vested interests" in federal spending were established—the recipients of relief, the local governments that received federal aid for their relief works projects, recipients of federal farm payments, and many others. Throughout the second half of the decade they resisted, with marked success, all

attempts to reduce federal "recovery and relief" expenditures. Their resistance had too much political pressure behind it to be crushed. Not until 1941, when the greater exigencies of defense procurement overrode the vested interests in federal "relief" and farm aid expenditures, could these "emergency" expenditures be effectively lowered.

AGENCIES

American governmental functions are divided among three major classes of political units—the federal government, the 48 states, and the 175,000 or more local units. For the most part, the activities of

TABLE 3
PERCENTAGE DISTRIBUTION OF GOVERNMENTAL
EXPENDITURE BY DISBURSING AGENCIES,
SELECTED YEARS 1890-1940

| Year | Federal | State | Local | Total |
|------------|---------|-------|-------|-------|
| 1890 . . . | 35 6 | 9 9 | 54 5 | 100 0 |
| 1903 . . . | 31 6 | 12 7 | 55 7 | 100 0 |
| 1913 . . . | 26 8 | 13 6 | 59 6 | 100 0 |
| 1919 . . . | 87 5 | 3 0 | 9 5 | 100 0 |
| 1923 . . . | 36 8 | 14 4 | 48 8 | 100 0 |
| 1929 . . . | 27 0 | 17 6 | 55 4 | 100 0 |
| 1933 . . . | 35 7 | 19 3 | 45 0 | 100 0 |
| 1936 . . . | 52 7 | 14 8 | 32 5 | 100 0 |
| 1939 . . . | 51 2 | 19 2 | 29 6 | 100 0 |
| 1940 . . . | 50 4 | 49 6 | | 100 0 |

Derived from The Conference Board, *The Economic Almanac for 1941-42* (the Board, New York, 1941), p. 358.

these bodies complement each other, each class of unit presumably performing the functions for which it is inherently best fitted. Obvious examples of this arrangement are the federal government's control of foreign relations and currency, and its maintenance of a navy. Local units provide fire protection and sanitary facilities. One class of government sometimes supplements an activity primarily administered by another, or by others. States have assumed part of the burden of education and highway maintenance functions formerly exclusively local; the federal Bureau of Investigation sup-

plements local protection of life and property. Occasionally, two governmental bodies cover the same function, with consequent overlapping and inefficiency; in federal and local handling of emergency relief during the middle 1930's, there were many such instances.

Neither functions nor expenditures are distributed in any predetermined fixed proportion among the three classes of govern-

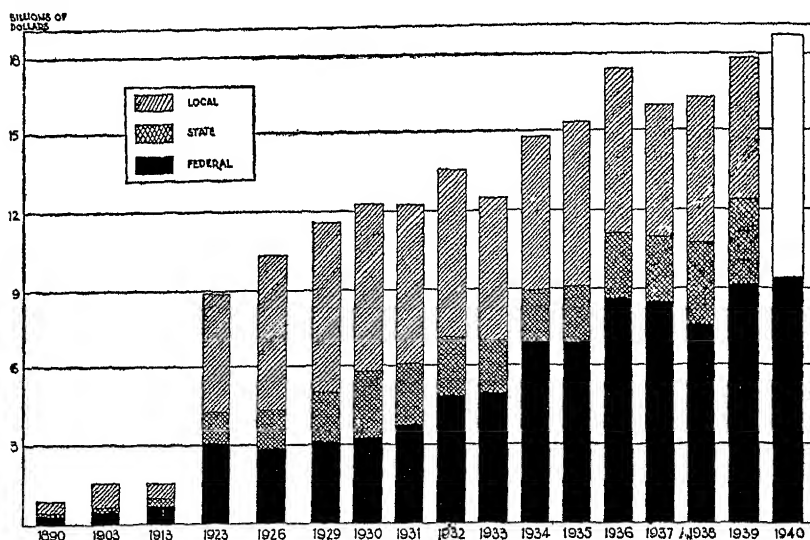


CHART I. AMERICAN GOVERNMENTAL EXPENDITURE BY DISBURSING AGENCIES, 1890-1940

mental units. In periods of national emergency—during the World War I years, in the “recovery” years of the later 1930's, and again as a consequence of the “defense” expenditures that began in 1940, for example—federal expenditures dominated the national total. At other times, as shown in Table 3, the federal proportion is from one-fourth to one-third. During the 1920's, local governments were responsible for one-half to three-fifths of the expenditure total. But this proportion will probably never be repeated. The expansion of federal expenditures as a result of New Deal and war developments is likely to dominate the proportions of American governmental expenditure for many years to come. The state governments, too, have during the past two decades expanded their functions much more rapidly than have the local governments; indeed,

through shifting of functions and the development of state aid, they have relieved local units of important items of expenditure that were formerly exclusively local. State governments, heretofore relatively unimportant as disbursing agencies, seem likely to assume a more important role in the future.

PURPOSES

Only when considered in relation to the disbursements of other classes of government, do the purposes of the expenditures of each class of government become significant. An examination of federal expenditures alone would give a false picture of the relative support given to the various public functions in the United States. Were state or local expenditures studied exclusively, a similar distortion would result. To understand the purposes of *American* public expenditures, the outlays of all governmental units must be placed in juxtaposition.

Fortunately, two calculations—for 1929 and for 1938—have been made of the functional distribution of American governmental expenditure. These calculations are presented in Table 4. As of 1929, a year fairly representative of governmental expenditure during the 1920's, nearly \$2,500,000,000, almost one-quarter of the net total and one-fifth of the gross total of American governmental expenditure, was devoted to the schools of the country. Construction and maintenance of highways and streets, and national defense, ranked next in importance.

Nine years later governmental expenditures were over \$5,000,000,000 higher, some four-fifths of which difference was accounted for by the expansion of expenditures for social welfare and relief. The \$4,661,000,000 expended for this purpose in 1938 gave this function leading rank. Less was spent for schools and for highways and streets in 1938 than in 1929, so that the relative importance of these two functions had declined considerably.

Beginning with the federal 1941 fiscal year, national defense expenditures experienced a tremendous and accelerating expansion. For 1941 they represent over one-fourth of a total of governmental

TABLE 4
FUNCTIONAL DISTRIBUTION OF AMERICAN GOVERNMENTAL EXPENDITURE, 1929 AND 1938
(Amounts in billions)

| Purpose of Disbursement | Federal | | | | | | State | | | | | | Local | | | | | | Total | | | | | |
|--------------------------------------|---------|-------|--|---------|-------|--|---------|-------|---------|--------|---|---------|--------|---------|-------|--------|----------|-------|--------|----------|-------|--------|---|--|
| | 1929 | | | 1938 | | | 1929 | | | 1938 | | | 1929 | | | 1938 | | | 1929 | | | 1938 | | |
| | Amount | % | | Amount | % | | Amount | % | | Amount | % | | Amount | % | | Amount | % | | Amount | % | | Amount | % | |
| | \$ | | | \$ | | | \$ | | | \$ | | | \$ | | | \$ | | | \$ | | | \$ | | |
| Education | 16 | .4 | | 177 | 2.2 | | 548 | 27.4 | 818 | 18.7 | | 1,926 | 27.0 | 3,418 | 24.1 | | 2,490 | 19.1 | | 2,413 | 13.3 | | | |
| Highways | 97 | 2.5 | | 260 | 3.4 | | 669 | 33.5 | 900 | 20.7 | | 1,170 | 16.4 | 510 | 8.3 | | 1,936 | 14.8 | | 1,670 | 9.2 | | | |
| Social welfare, and health | 87 | 2.2 | | 2,707 | 35.2 | | 254 | 12.7 | 1,423 | 32.7 | | | | 531 | 8.6 | | | | | 4,661 | 25.6 | | | |
| National defense | 1,568 | 38.8 | | 1,610 | 20.9 | | | | 12 | 2 | | | | | | | | | | 1,622 | 8.9 | | | |
| Protection | | | | 44 | 6 | | 175 | 8.7 | 138 | 3.1 | | 2,918 | 41.0 | 566 | 8.2 | | 6,029 | 46.2 | | 748 | 4.1 | | | |
| Agriculture and natural resources | 194 | 4.9 | | 1,000 | 13.0 | | 65 | 3.3 | 73 | 1.7 | | | | 3 | | | | | | 1,076 | 5.9 | | | |
| General government and miscellaneous | 620 | 15.7 | | 902 | 11.8 | | 149 | 7.4 | 738 | 17.0 | | | | 2,001 | 32.6 | | | | | 3,641 | 20.0 | | | |
| Interest. | 680 | 17.4 | | 926 | 12.0 | | 94 | 4.7 | 121 | 2.8 | | 706 | 9.9 | 592 | 9.6 | | 1,481 | 11.3 | | 1,639 | 9.0 | | | |
| Net total | \$3,262 | 82.9 | | \$7,626 | 99.2 | | \$1,954 | 97.7 | \$4,223 | 96.9 | | \$6,720 | 94.3 | \$5,621 | 91.4 | | \$11,936 | 91.4 | | \$17,470 | 96.0 | | | |
| Debt retirement | 673 | 17.1 | | 65 | 8 | | 47 | 2.3 | 135 | 3.1 | | 406 | 5.7 | 529 | 8.6 | | 1,126 | 8.6 | | 729 | 4.0 | | | |
| Gross total | \$3,935 | 100.0 | | \$7,691 | 100.0 | | \$2,001 | 100.0 | \$4,358 | 100.0 | | \$7,126 | 100.0 | \$6,150 | 100.0 | | \$13,062 | 100.0 | | \$18,199 | 100.0 | | | |

Sources: 1929 figures from National Industrial Conference Board, *Cost of Government in the United States, 1929-1930*, p. 20. 1938 figures from *U. S. Treasury Bulletin*, August 1939, p. 4. The classification and combination of figures in these two sources are not strictly comparable, but the comparison is fair enough in its broad outlines.

expenditure in excess of \$22,000,000,000. For 1942, and for subsequent years if the armament program is long continued, the proportion will be still higher.

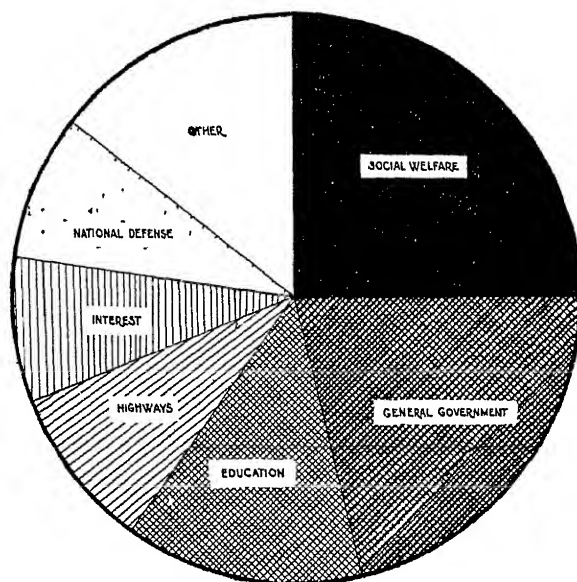


CHART II PURPOSES OF AMERICAN GOVERNMENTAL EXPENDITURE, 1938

Costs of each function are not distributed *pro rata* among the three classes of government—federal, state, and local. Education is primarily a local function; federal and state outlays for school purposes in most states merely supplement local contributions. On the other hand, practically all of the expenditure for national defense is undertaken by the federal government. Over half of the expenditures for social welfare are made by the federal government, and three-quarters of the balance is made by the states. State expenditures for highways are nearly double those of the local units, and these in turn are double federal payments for this purpose.

PURPOSES OF FEDERAL EXPENDITURE

Article I, Sec. 8 of the federal Constitution grants the federal government, through Congress, certain specified powers—provision for the national defense, conduct of diplomatic relations with other

nations, control of immigration and naturalization, regulation of foreign and interstate trade, and control of the monetary system. Nowhere is there mention of any power to construct internal improvements, or to aid agriculture, commerce, industry, or the merchant marine, or to relieve the distress caused by business depression, or to construct lighthouses, or to engage in any of the multitude of "service" functions which the federal government performs today. And the Tenth Amendment provides that "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." But the first paragraph of Article I, Sec. 8 gives Congress power "To lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common defense and general welfare of the United States." The construction of that "general welfare clause" was fiercely contested during the first fifty years of the country's history.⁸ Should it be construed strictly, and the role of the federal government be limited to that of arbiter between the states and international "front" for the union? Or should it be construed liberally, and the way be opened for practically unlimited federal activity? Historical authority supported the case for the "strict constructionists." That of the "loose constructionists" rested on popular approval. And ultimate victory, as will be evident in the following pages, was with the "loose constructionists."

Although federal powers to regulate private activity come constantly under the eyes of the courts, federal activities and expenditures are relatively free from judicial interference. An individual or other plaintiff rarely has an interest so affected by the expenditure of public funds—unless the activity regulates or otherwise limits his personal or business rights—that he may invoke the judgment of the courts. When the state of Massachusetts and an individual taxpayer

⁸ The issue turned upon the comma after the word "excises." Was it intended to mark off an independent clause, so that Congress was given power "to pay the debts and provide for the common defense and general welfare"? Or, in consonance with eighteenth-century writing style, was it casual so that the grant of power should read, "To lay and collect taxes, etc (in order) to pay the debts and provide for the common defense and general welfare"? Under the first construction a real "general welfare" power is granted, under the second, a limitation is placed on federal tax powers. The records of the Constitutional Convention would indicate that the second, narrower construction was in the minds of the delegates.

sought to enjoin the expenditure of federal funds under the Maternity Act of 1921, the Supreme Court held that Massachusetts as a state was not affected and had no interest to entitle it to maintain suit,⁴ and that the relative tax contribution of the individual appellant was too minute to give him sufficient interest to sustain suit.⁵ In reviewing the case of special processing tax revenues earmarked to Agricultural Adjustment Act payments, however, the Supreme Court took a federal function under consideration and judged it adversely, but only because the earmarking of the processing taxes gave the taxpayers a traceable interest in the function under review.⁶

National defense

Except during the 1930's, expenditures for war, in preparation for war, and as a consequence of war, have been the outstanding feature of the federal budget. For one hundred and forty years, as shown in Table 5, they molded the history of federal expenditure

Federal government payments on the army, on the navy, and on the Revolutionary debt accounted for from five-sixths to nine-tenths of total expenditures during the first two decades. Under Federalist rule, from 1789 to 1800, the proportion of military expenditures to total federal expenditures tended to increase; the Jeffersonian program of peace and economy lowered it in the decade following. The War of 1812 rocketed military and naval expenditure, loaded a new war debt upon the country, and laid the foundation for additional pension payments. By 1835 this war debt was paid off, but a new one was piled up for the prosecution of the Mexican War. War pension payments varied in amount; the tendency of such payments to decrease as veterans died off was counteracted by Congressional eagerness to increase pension allowances.⁷ Expenditures for the

⁴ *Massachusetts v. Mellon*, 262 U. S. (1922) 447.

⁵ *Frothingham v. Mellon*, 262 U. S. (1922) 447.

⁶ *U. S. v. Butler*, 297 U. S. (1936) 1.

⁷ A summary history of veterans' aid legislation will be found in National Industrial Conference Board, *The World War Veterans and the Federal Treasury* (New York, 1932), p. 3, fuller studies are W. H. Glassons, *Federal Military Pensions in the United States* (Carnegie Endowment for International Peace, 1918) and G. A. Weber and L. F. Schmeckebier, *The Veterans' Administration* (Brookings Institution, 1934).

army and navy increased steadily as these establishments grew in size and equipment.

Heavy military expenditures occasioned by the Civil War marked the 1860's. Fifteen years thereafter were spent bringing the army and navy down to a peacetime level and reducing the war debt—the low point was reached in 1886. Federal military and civil expenditures expanded steadily from 1887 to 1916. A steel navy replaced the wooden one, khaki replaced the historical blue of the army. The Spanish War, short in duration, gave another fillip to military and naval expenditures. And pension payments, instead of

TABLE 5
OUTLINE OF FEDERAL EXPENDITURE, 1789-1940
(Amounts in millions)

| Yearly Average | Civil and Miscellaneous ¹ | War Department ² | Navy Department ² | Pensions and Veterans' Aid | Interest | Total |
|----------------|--------------------------------------|-----------------------------|------------------------------|----------------------------|--------------|-------|
| 1789-1800 | \$ 1 | \$ 1 | \$ 1 | ³ | \$ 3 | \$ 6 |
| 1801-1810 | 2 | 2 | 2 | ³ | 3 | 9 |
| 1811-1820 | 3 | 11 | 5 | ³ | 5 | 24 |
| 1821-1830 | 4 | 4 | 3 | \$ 1 | 4 | 16 |
| 1831-1840 | 9 | 8 | 5 | 3 | ³ | 25 |
| 1841-1850 | 9 | 13 | 8 | 2 | 2 | 34 |
| 1851-1860 | 28 | 16 | 12 | 2 | 3 | 60 |
| 1861-1865 | 31 | 548 | 65 | 5 | 35 | 684 |
| 1866-1870 | 63 | 128 | 28 | 23 | 135 | 378 |
| 1871-1880 | 73 | 39 | 20 | 33 | 106 | 272 |
| 1881-1890 | 84 | 42 | 17 | 72 | 54 | 268 |
| 1891-1900 | 114 | 81 | 39 | 144 | 34 | 411 |
| 1901-1910 | 164 | 151 | 100 | 148 | 25 | 587 |
| 1911-1916 | 200 | 196 | 137 | 166 | 23 | 723 |
| 1917-1921 | 3,654 ⁴ | 3,399 | 981 | 337 | 571 | 8,942 |
| 1922-1930 | 831 | 401 | 353 | 764 | 840 | 3,188 |
| 1931-1933 | 1,976 | 468 | 354 | 927 | 633 | 4,358 |
| 1934-1940 | 5,417 | 627 | 569 | 841 | 871 | 8,325 |

¹ After 1916 excludes civil expenditures under War and Navy Departments

² After 1916 includes civil expenditures under War and Navy Departments

³ Less than \$750,000

⁴ Includes war expenditures not made through War and Navy Departments

Derived from *Statistical Abstract*, 1940, p. 168

declining as Mexican War and Civil War veterans died off, increased astoundingly as pension allowances were liberalized and Spanish War veterans were brought on the list. During the early '80's, annual pension payments had averaged \$60,000,000; by 1916 they were over \$160,000,000.

American participation in World War I again catapulted the military expenses of the federal government. Expenditures for the army and navy, for military compensation, and for interest on the war debt, reached a stupendous maximum of over \$12,500,000,000 in the fiscal year 1918-1919. The machinery of war was ultimately dismantled. War and Navy Department expenditures (including some for civil purposes) touched a \$700,000,000 low in 1924. Interest payments on the war debt were at their peak—over \$1,000,000,000—in 1921; they declined thereafter. But pensions and veterans' aid payments increased. An efficient veterans' lobby obtained the progressive liberalization of veterans' aid allowances and in 1924 forced the passage of a bonus bill, over presidential veto, involving cash payments of \$50,000,000 and a deferred payment of nearly \$3,700,000,000 in 1945.⁸ By 1930, the annual pension and veterans' aid bill was \$820,000,000. In that year, payments for national defense and those arising out of America's participation in World War I exceeded two billion dollars—nearly two-thirds of the federal government's total budget.

National defense appropriations were cut during the depression years of the early 1930's, and President Roosevelt succeeded in reducing the veterans' aid appropriation from a high of \$985,000,000 in 1932 to \$567,000,000 in 1934. But in 1936, over presidential veto, Congress authorized immediate cash payment of the soldiers' bonus, adding \$1,700,000,000 to federal expenditures for the 1936 fiscal year

⁸ The War Risk Insurance Act of 1917, intended to preclude and obviate the abuses of a World War veterans' pension system, covered provision for the dependents of members of the armed forces during the period of their service, compensation for death or disability resulting from war service, authorization for hospital service, a policy of rehabilitation for permanently injured veterans, and a system of insurance under which the government assumed the extra risk cost attached to military service. The pension and bonus legislation of the 1920's added to the service compensation provided by the Act of 1917. The Bonus Act of 1936 provided for payment of the bonus nine years ahead of the date set by the original Adjusted Compensation Act of 1924.

and \$557,000,000 to the payments for the year following. In 1935, moreover, the United States started to rearm. As world conditions grew darker, the pace of rearmament was accelerated. In 1939, national defense expenditures exceeded \$1,000,000,000, more than double the figure for 1934. The advent of World War II further intensified American rearmament. By 1941, the federal "defense" procurement program had become, in effect, a race against time to prepare for probable involvement in the war, and at the same time extend "all aid" to Britain. National defense expenditures for fiscal year 1941 amounted to over \$6,000,000,000. As of December 1941, with war against the Axis powers an actuality, annual military and naval budgets of thirty to sixty billion dollars were forecast.

Civil expenditure prior to the Depression

Civil functions were held to a minimum during the first sixty years of the federal government's history. Jackson's Maysville veto in 1830 checked desultory activity in the field of internal improvements, the Cumberland Road, constructed with federal funds between 1811 and 1852, was an exceptional venture. Not until the 1850's did the federal government quietly but seriously expand its civil functions. The Department of the Interior had been created in 1849. By 1860, civil expenditures constituted nearly one half of the \$63,000,000 federal budget.

Overhead costs of federal government grew, after the Civil War, as the country grew. Now, however, the national administration was definitely widening the scope of its civil activities. The Interstate Commerce Commission was established in 1887, agriculture was given an executive department and a Cabinet office in 1889, the Department of Commerce and Labor was created in 1903, and the Federal Trade Commission in 1914. Appropriations for deepening of rivers and harbors—the ill-famed "pork barrel" legislation—were a feature of the period. Federal civil expenditures were \$61,000,000 in 1880; in 1915 they amounted to \$269,000,000.

Pre-existing functions were expanded and many small new ones added from 1915 to 1930. Through the newly established federal land banks and the Agricultural Marketing Act of 1929, over \$500,-

000,000 of federal funds was invested in agricultural credit. According to one authority, two-fifths of the \$800,000,000 increase in the annual federal civil expenditures between 1915 and 1930 may be ascribed to new agencies and new work within the older bureaus and establishments, and three-fifths to the effects of price changes and the expansion of older activities.⁹

"Recovery and relief" functions since 1931

By 1932, pressure upon the federal government for positive action to check the growing depression had become too insistent to be

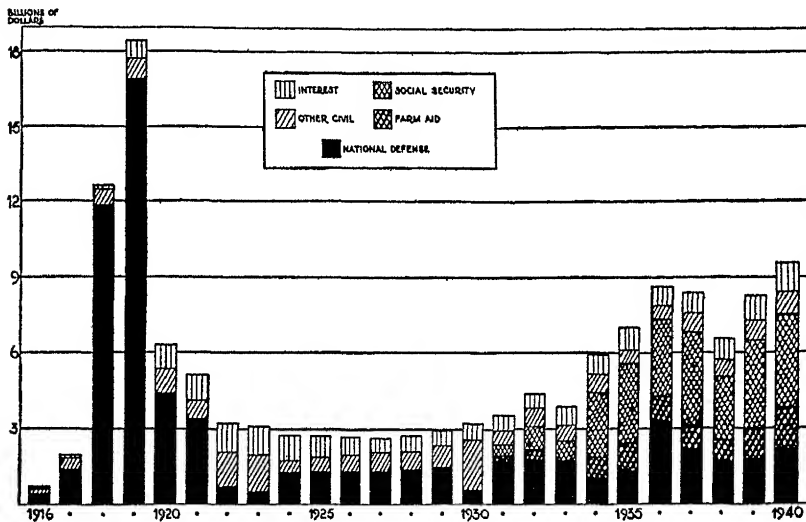


CHART III FEDERAL EXPENDITURES, 1916-1940

longer ignored. In that year, the Reconstruction Finance Corporation was established to advance federal funds to financial institutions and railroads and to lend up to \$300,000,000 to states and localities for relief purposes; by March 1933 its loans outstanding totaled \$1,800,000,000. A federal home loan bank system was established with \$125,000,000 of initial capital provided by the Treasury, additional federal funds were invested in the federal land banks, and \$200,000,000 was made available to the Secretary of Agriculture for

⁹ Carrol H. Woody, "The Growth of Governmental Functions," in *Recent Social Trends in the United States* (McGraw-Hill Book Co., New York, 1933), Vol. II, p. 1920.

direct emergency loans to farmers. But the "depression outlays" of the Hoover administration were a modest prelude to the tremendous New Deal "recovery and relief" expenditures.

President Roosevelt posited a new federal function—to stem depression and stimulate recovery—in the course of his first year in office. The program had many facets.¹⁰ Some, the monetary and banking laws for example, without committing the government to new functions or additional expenditure, had far-reaching economic effects. Others involved new governmental activities and new governmental costs.

First "recovery" engine geared into action by the Roosevelt administration was the Reconstruction Finance Corporation. Within the ten months from March through December 1933, more than \$1,800,000,000 of RFC funds was lent to or invested in weakened financial institutions; another \$1,850,000,000 was so advanced in 1934. Most of these "shock funds" were used to buttress shaky banks—either to prevent their collapse or to make them eligible for membership in the Federal Deposit Insurance System. Over \$600,000,000 was invested in the capital of federal farm credit institutions. In addition to these \$3,700,000,000 of advances made during the first twenty-two months of the Roosevelt administration, RFC was authorized to transfer \$1,000,000,000 to federal agencies for relief expenditure. RFC's loans and investments have been or will be eventually repaid in greater part—the transfers were outright expenditures.

Reconstruction Finance Corporation, created by the Hoover administration, was and is an independent, incorporated credit institution, but its \$500,000,000 stock is entirely owned by the federal Treasury. And in the absence of a private market for its notes, the sale of which provided its working capital, the Treasury purchased all issues. Over \$4,000,000,000 were outstanding on December 31, 1936, over \$1,700,000,000 on May 31, 1941. In effect, then, RFC was merely an agency through which the federal Treasury made investments and advanced "recovery" funds. Repayments of old loans

¹⁰ A summary analysis of the Roosevelt "recovery program" is given in William J. Shultz and M. R. Caine, *Financial Development of the United States* (Prentice-Hall, New York, 1937), Chs. XXVIII and XXIX.

TABLE 6—FEDERAL EXPENDITURE, SELECTED YEARS 1922-1942

| Purpose of Expenditure | "Normalcy" | | | | | Reces- sion | "New Deal" | | | | | National Defense |
|--|------------|---------|---------|---------|---------|----------------|------------|--------------------|---------|---------|----------|---------------------|
| | 1922 | 1924 | 1926 | 1928 | 1930 | | 1932 | 1934 | 1936 | 1938 | 1940 | |
| Amounts (in millions) | | | | | | | | | | | | |
| Agricultural aid | a | a | a | a | a | \$ 443 | \$ 780 | \$ 938 | \$ 860 | \$1,567 | \$ 1,113 | |
| Public works | a | a | a | a | a | 450 | 698 | 730 | 783 | 948 | 864 | |
| Relief and work relief | .. | .. | .. | .. | .. | 500 | 1,845 | 2,292 | 1,869 | 1,906 | 929 | |
| Social security grants to states | .. | .. | .. | .. | .. | . | . | 28 | 271 | 357 | 463 | |
| Old age and pension retirement funds | | | | | | | | | | | | |
| Other civil payments | \$ 581 | \$ 568 | \$ 610 | \$ 657 | \$ 969 | 755 | 770 | 611 | 533 | 658 | 838 | |
| Total civil | \$ 581 | \$ 568 | \$ 610 | \$ 657 | \$ 969 | \$2,148 | \$4,093 | \$4,599 | \$4,990 | \$6,288 | \$ 5,253 | |
| National defense | 939 | 657 | 595 | 657 | 731 | 702 | 540 | 912 | 1,028 | 1,559 | 18,000 | |
| Veterans administration | 703 | 646 | 742 | 752 | 793 | 985 | 557 | 2,351 ^b | 582 | 557 | 565 | |
| Interest | 991 | 941 | 832 | 732 | 659 | 599 | 757 | 749 | 926 | 1,041 | 1,275 | |
| (Total | \$3,214 | \$2,812 | \$2,779 | \$2,798 | \$3,152 | \$4,434 | \$5,947 | \$8,611 | \$7,526 | \$9,445 | \$25,093 | |
| Percentage Distribution | | | | | | | | | | | | |
| Agricultural aid | a | a | a | a | a | 10 0 | 13 1 | 10 9 | 11 4 | 16 6 | 4 4 | |
| Public works | a | a | a | a | a | 10 1 | 11 7 | 8 5 | 10 4 | 10 0 | 3 4 | |
| Relief and work relief | .. | .. | .. | .. | .. | 11 3 | 31 0 | 26 6 | 24 8 | 20 2 | 3 7 | |
| Social security grants to states | .. | .. | .. | .. | .. | | | 0 3 | 3 6 | 3 8 | 1 8 | |
| Old age and pension retirement funds | | | | | | | | | 7 1 | 7 0 | 3 3 | |
| Other civil payments.. | 18 1 | 20 2 | 22 0 | 23 5 | 30 7 | 17 0 | 12 9 | 7 1 | 9 0 | 9 0 | 4 2 | |
| Total civil | 18 1 | 20 2 | 22 0 | 23 5 | 30 7 | 48 4 | 68 7 | 53 4 | 66 3 | 66 6 | 20 9 | |
| National defense | 29 2 | 23 3 | 21 5 | 23 5 | 24 2 | 15 8 | 9 1 | 10 6 | 13 7 | 16 5 | 71 7 | |
| Veterans administration | 21 9 | 23 0 | 26 7 | 26 9 | 25 2 | 22 2 | 9 4 | 27 3 ^b | 7 7 | 5 9 | 2 2 | |
| Interest | 30 8 | 33 5 | 29 9 | 26 2 | 20 9 | 13 5 | 12 7 | 8 7 | 12 3 | 11 0 | 5 1 | |
| Total | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | |

^a Relatively small amounts included with "Other civil payments"^b Includes \$1,700,000,000 bonus payment^c Estimates as of June 1, 19411922-1940 figures from United States Secretary of the Treasury, *Annual Reports*, 1942 advance estimate as of October 1941 from United States Bureau of the Budget.

have exceeded new advances since 1935, and RFC itself has been paying off its Treasury-held notes.

In a frontal attack on the depression, titanic federal expenditures were made on public works, on the Keynesian theory that such payments would eventually produce a multiplied increase of private purchasing power. The National Industrial Recovery Act of 1933 carried a \$3,300,000,000 appropriation for public works, with provision for matching of federal funds by the states and localities for which the public works were constructed and for public works loans to state and local units. When it was seen that the Public Works Administration could not promptly institute a "heavy" works program of such magnitude, a Civil Works Administration was established in November 1933 to create "light" works projects, with funds transferred from PWA.¹¹ Thus, it was hoped, the twin aims of "recovery" and "relief" could be pursued simultaneously. CWA lasted only six months, during which time it expended \$939,000,000. Meanwhile, PWA continued a slow development,¹² and federal relief grants to the states were maintained.

In 1935 occurred two important developments in the federal "recovery and relief" program—the Work Relief Act and the Social Security Act. The Work Relief Act established a Works Progress Administration with a \$4,990,000,000 appropriation to be expended on specified classes of public works projects in such manner as to provide a maximum of "work relief." WPA expenditures were intended to be temporary, but this hope was doomed to disappointment. Either because the relief emergency continued or was believed to continue—the point is open to unresolvable dispute—WPA lingered on with supplementary appropriations. Even in 1941, with the defense boom creating labor shortages, WPA expended \$1,285,000,000.

The Social Security Act looked beyond the immediate emer-

¹¹ Best studies on the federal relief and social security programs are William Withers, *Financing Economic Security in the United States* (Columbia University Press, New York, 1939), and Josephine C. Brown, *Public Relief, 1929-1939* (Henry Holt, New York, 1940).

¹² See J. Kerwin Williams, *Grants-in-Aid under the Public Works Administration* (Columbia University Press, New York, 1939).

gency. It made no contribution to "recovery," and had only incidental bearing upon current relief needs. Instead it established a permanent basis for a nationally organized system of social security. The federal government undertakes to insure—or more correctly, to pay an old-age pension determined in amount by the wage received

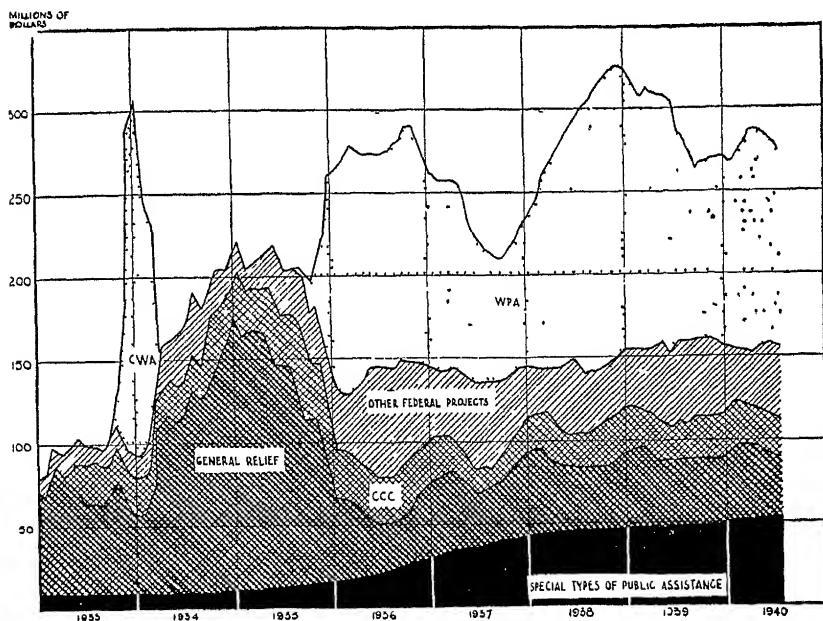


CHART IV. MONTHLY FEDERAL RELIEF EXPENDITURE, 1933-1940

by the pensioner prior to his retirement at or after 65 years of age, his dependents, and the period during which he paid payroll taxes¹³—to all employees except those engaged in agriculture, domestic service, state and local service, and certain other exempted occupations. By the close of 1940, nearly 50,000,000 prospective pensioners were on the federal rolls. Moreover, the federal government contributes one-half of state old-age pension or assistance payments up to a maximum federal contribution of \$20 per month to persons not covered adequately by the federal pension system. And, finally, the federal government makes grants-in-aid to the states¹⁴ for maternal

¹³ Payroll taxes are discussed on pp 465 and 532 of this volume.

¹⁴ Social security grants-in-aid are discussed on p. 105 of this volume

and child health, for crippled children, for dependent children, for vocational rehabilitation, for aid to needy blind individuals, and for public health purposes. Under the provisions of the 1935 act, as liberalized in 1939 and 1940, federal social security expenditures are bound to expand with each successive year as authorized payments increase. For fiscal year 1941 they amounted to \$1,084,000,000.

Farm relief was considered a problem separate and distinct from the general recovery program. Farm depression was not a temporary phenomenon, it had lasted, more or less unbroken, since 1920. Production in excess of domestic requirements threw a farm surplus upon the world market, and held American farm prices to the low world-price level. Manufactured goods, on the other hand, sheltered by a protective tariff, commanded prices considerably above comparable world prices. The Federal Farm Board, established in 1929, had lost \$184,000,000 of federal funds by vainly buying crop surpluses to hold for higher prices, without lasting aid to the farmer. The Roosevelt administration's solution for this problem was the Agricultural Adjustment Administration, created by the Farm Relief Act of 1933, which stimulated a rise of farm prices through crop reduction induced by federal bounties for the nonplanting of crops and the destruction of herds. Simultaneously, appropriations were made for soil conservation work which would preserve the arable areas of the country and also give farmers supplementary employment. In the peak year 1935, these two items cost nearly \$1,150,000,000. In January 1936, the AAA program was declared unconstitutional, primarily because of the earmarking of processing taxes to the crop reduction bounties.¹⁵ Congress immediately salvaged the AAA principle of controlled agricultural production by appropriating general treasury funds for withdrawing land from cultivation in the interest of soil conservation. Two years later, a new Agricultural Adjustment Act established farm aid on the basis of crop loans conditioned upon regulated production. Under the 1936 and 1938 laws, farm aid lost its emergency relief character and became an element of the regular civil budget. In fiscal year 1941, federal farm aid payments amounted to \$968,000,000.

¹⁵ See pp. 69 and 206 of this volume.

“Regular” civil functions since 1931

Faced with declining revenues, the Hoover administration sought to hold its deficits down by an “economy” program. For the fiscal year ended June 1933, civil departmental expenditures were brought to a “low” of \$638,000,000. While spending liberally on its emergency functions, the Roosevelt administration announced even more drastic economizing in the “regular” fields. Salaries were cut, services were pared. Civil departmental expenditures for the 1934 fiscal year were \$475,000,000. Subsequently, with rising prices, salary cuts were restored. As shown in Chart VI,¹⁶ the New Deal reform legislation added substantially to the personnel necessary to administer the various new functions assumed by the federal government. The trend of “ordinary” civil expenditures after 1934 was generally upward. By 1941 they amounted to \$811,000,000.

¹⁶ See p 125 of this volume.

CHAPTER IV

American Governmental Expenditure

(Concluded)

PURPOSES OF STATE EXPENDITURE

AFTER the early generally disastrous experiences of the state governments with canal construction, railroad aid, and bank aid, they tended during the nineteenth century to restrict their activities to a minimum. Agriculture was given some small assistance. State officials administered, very badly, the school funds obtained from the sale of "school lands." A few state hospitals and asylums were maintained. Otherwise, at the turn of the century, most of the states confined themselves to the bare "overhead" functions of government.

General functions

In the course of the past forty years, the scope of state activity has broadened startlingly. Masters of revenue sources denied to the local governments, the states have been forced to supplement, and in some cases take over, functions formerly the exclusive responsibility of local units. Advent of the automobile necessitated paved highways beyond the capacity of local governments to construct and maintain. At first, the state governments contributed to local highway activity by grants-in-aid, but most of them subsequently assumed sole responsibility for arterial highways. In 1939 state governments spent \$468,000,000 on the construction and \$206,000,000 on the maintenance of state-administered highways, plus an additional \$454,000,000 on highway bond interest, highway bond retirement, grants for local roads and streets, and other supplementary highway purposes.

TABLE 7
PURPOSES OF STATE EXPENDITURE,
1913, 1923, 1931, AND 1938

| Purpose of Disbursement | 1913 | 1923 | 1931 | 1938 |
|--|---------|-----------|-----------|-----------|
| <i>Amounts (in millions)</i> | | | | |
| General government | \$ 43 9 | \$ 83 7 | \$ 147 5 | \$ 164 8 |
| Protection to person and property | 25 8 | 54 8 | 88 6 | 130 8 |
| Development and conservation of national resources | | 52 3 | 84 3 | 97 3 |
| Health, sanitation | 7 1 | 24 0 | 40 0 | 45 5 |
| Highways | 26 1 | 383 7 | 997 7 | 1,033 3 |
| Social welfare and corrections | 94 0 | 197 9 | 309 2 | 1,369 4 |
| Education | 139 5 | 382 0 | 632 1 | 927 3 |
| Recreation | 2 7 | 4 4 | 23 4 | 12 5 |
| Miscellaneous | 8 5 | 64 8 | 59 2 | 93 5 |
| Net total | \$316 5 | \$ 895 0 | \$1,447 3 | \$3,179 2 |
| | 31 1 | 351 6 | 934 8 | 695 2 |
| total | \$347 6 | \$1,247 6 | \$2,382 1 | \$3,874 4 |
| Interest | 14 2 | 50 4 | 110 8 | 125 5 |
| Public utilities | 20 8 | 12 6 | 15 9 | 223 8* |

Percentage Distribution of Net Total

| | | | | |
|--|-------|-------|-------|-------|
| General government | 12 6 | 6 7 | 6 2 | 4 3 |
| Protection to person and property | 7 4 | 4 4 | 3 7 | 3 4 |
| Development and conservation of national resources | | 4 2 | 3 5 | 2 5 |
| Health, sanitation | 2 0 | 1 9 | 1 7 | 1 2 |
| Highways | 7 5 | 30 7 | 41 9 | 26 7 |
| Social welfare and corrections | 27 1 | 15 9 | 13 0 | 35 3 |
| Education | 40 2 | 30 6 | 26 5 | 24 0 |
| Recreation | 0 8 | 0 4 | 1 0 | 3 |
| Miscellaneous | 2 4 | 5 2 | 2 5 | 2 4 |
| Net total | 100 0 | 100 0 | 100 0 | 100 0 |
| Capital expenditure | 8 9 | 28 2 | 39 3 | 17 9 |

*Includes \$204,000,000 cost payments in connection with state liquor monopolies

Derived from United States Bureau of the Census, *Financial Statistics of States* series.

In education, too, state contributions have risen. From 1900 on, educational grants-in-aid for school purposes assumed ever larger importance. By 1938 total state school expenditures exceeded \$900,000,000, and all indications point to still further expansion of state activity in this field. California and Delaware have made education completely a state function; North Carolina provides the standard minimum educational requirement, the local districts being responsible only for excess over that minimum. In other states, school authorities are campaigning either for similar state assumption of the school functions, or for larger state grants-in-aid.

Before the depression, the state governments left the field of social welfare activities largely to the local governments. While state expenditures for charities and hospitals, and for health and sanitation increased each year, they grew less rapidly than other items of state expenditure, and their relative importance in the state budgets decreased. In 1931 they constituted somewhat less than one-seventh of the total of state expenditure. Depression forced most states to engage in relief activities, and their relief expenditures from July 1933 through June 1935 amounted to \$533,000,000. New York's TERA (Temporary Emergency Relief Administration) spent \$739,000,000 between October 1931 and June 1937.

Just as state emergency relief expenditures were tapering off, the Social Security Act of 1935 imposed new expenditure obligations upon the states. To take advantage of the credit allowed in the federal payroll tax,¹ all forty-eight states passed unemployment insurance laws. These laws generally provide that after a three to six weeks' waiting period, the unemployed person shall for fifteen to sixteen weeks be paid one-half of his previous salary, to a maximum of \$15 a week. During the states' 1939-1940 fiscal year, 6,234,335 unemployment insurance claims were allowed, and over \$450,000,000 was paid out. All states now have old-age pension laws. Average monthly pensions in 1940 varied from \$7.57 in Arkansas to \$37.95 in California, with a national average of \$20.11; nearly 2,000,000 aged people were receiving state assistance in June 1940, at a total annual cost to the states of \$450,000,000. In the forty states

¹ See p. 532 of this volume.

whose child-aid laws had been approved by the Social Security Board, 831,000 children in 346,000 families were receiving an average of \$30 per family per month. Approximately 72,000 blind people in thirty-nine states were receiving an average allowance of \$24 per month. Quite generally the states are assuming the function of coordinating the work of county and city welfare units.² Social welfare expenditures already constitute the most important class of state expenditure, outranking highway and education costs, and for some time they will continue to increase.

Individual states vary widely as to the relative support they give to individual functions. This variation is concealed by the aggregate figures presented in Table 7, and in this respect the figures may prove misleading. In 1938, for example, New York was spending less than 6 per cent of its current state budget on highway maintenance, whereas the proportion for Vermont and New Hampshire was around 35 per cent. Similarly, state expenditures on education varied from 54 per cent of the current state budget in North Carolina to less than 8 per cent in Rhode Island. Over 30 per cent of the Rhode Island state budget was devoted to payment of unemployment compensation, while in 1938 this item did not appear at all in the accounts of thirty-five states.

Capital outlays

Also worthy of note is the growth of capital outlays for construction in state government budgets. In 1913 capital outlays were less than 10 per cent of the total of state expenditure. In 1923 the proportion was 28 per cent. In 1931 it was 39 per cent. As a consequence of the poor market for state bonds during the 1930's, and influenced no doubt by the prevailing economic pessimism, state legislatures sharply reduced authorizations for new capital construction. As of 1938, state capital outlays were \$240,000,000 lower than in 1931, and their proportion of total state expenditure for the year was down to 18 per cent.

State capital outlays during the 1920's and early 1930's were de-

² Leonard D. White, *Introduction to the Study of Public Administration* (The Macmillan Co., New York, 1939), p. 173.

voted mainly to road construction. The states originally set specific programs of highway building for themselves. As time went on, many of these construction programs were expanded to meet new conditions. Nevertheless, as programs, they were certain some day to be completed. For many states, that day has already arrived, and their expenditures on highway construction have already fallen off sharply. As more and more states complete their present highway programs, this relative reduction of outlays is necessarily reflected in the figure of total capital expenditure for all states.

Of course, should any considerable number of the states in the near future assume new functions involving large construction costs—as the state government in California relieved the local units of financial responsibility for the state's educational system—a new impetus might be given to state outlays.

PURPOSES OF LOCAL EXPENDITURE

Local governmental functions, more than federal or state activities, touch tangibly home to every man, woman, and child. School districts and municipalities are still primarily responsible for education. Cities, counties, and towns spend more than the state governments upon streets and roads. The policeman or sheriff who represents "law and order," the fireman, the visiting nurse and the health clinic, the public park, the water-supply system—all are manifestations of local government.

Data are not available to give a complete functional distribution of local expenditures—the payments made by cities, villages, counties, towns, school districts, and a bewildering variety of special districts—for any single year, much less to show the development and changing distribution of these expenditures over a period of time. But the federal Census Bureau has intermittently published figures on the expenditures of the larger cities—for a long time all cities with populations over 30,000, but more recently only cities with populations over 100,000. County expenditure figures are to be had for a few scattered years. For town, school district, and special district expenditures, we have only the bare totals—\$1,536,000,000, \$253,000,000, and \$261,000,000 respectively in 1932.

Cities

Education is the largest item of city expenditure. Social welfare, creation and maintenance of streets, police and fire protection, and health and sanitation follow in order of importance.

TABLE 8
THE PURPOSES OF CITY EXPENDITURE,
SELECTED YEARS 1905-1938

| Purpose of Disbursement | City Population over 30,000 ¹ | | | | City Population over 100,000 ² | | | |
|---|--|---------|----------|-----------|---|-----------|-----------|-----------|
| | 1905 | 1913 | 1923 | 1930 | 1930 | 1934 | 1938 | |
| <i>Amount (in millions)</i> | | | | | | | | |
| General government | \$ 33 8 | \$ 67 0 | \$ 124 7 | \$ 204 7 | \$ 179 9 | \$ 145 2 | \$ 183 7 | |
| Public safety | 87 9 | 127 1 | 284 8 | 441 5 | 365 9 | 307 4 | 360 4 | |
| Health, sanitation | 52 1 | 88 9 | 215 4 | 334 0 | 279 6 | 176 8 | 202 2 | |
| Streets | 100 2 | 161 4 | 324 6 | 604 9 | 517 7 | 199 4 | 259 3 | |
| Social welfare and corrections | 21 9 | 40 4 | 87 7 | 172 9 | 156 4 | 353 9 | 523 0 | |
| Education | 125 4 | 198 7 | 700 8 | 1,002 7 | 777 0 | 567 0 | 732 2 | |
| Recreation | 22 1 | 45 4 | 74 7 | 126 9 | 110 1 | 90 8 | 93 6 | |
| Miscellaneous | 6 1 | 21 8 | 60 7 | 112 2 | 98 9 | 130 4 | 120 1 | |
| Net total | { current capital | \$307 5 | \$523 0 | \$1,337 9 | \$2,112 2 | \$1,737 6 | \$1,745 0 | \$2,097 3 |
| | | 142 0 | 227 6 | 535 5 | 887 7 | 747 7 | 225 9 | 377 2 |
| | { total | \$449 5 | \$750 6 | \$1,873 4 | \$2,999 9 | \$2,485 3 | \$1,970 9 | \$2,474 5 |
| Interest | | 52 7 | 109 7 | 227 9 | 405 2 | 341 4 | 352 9 | 207 1 |
| Enterprises | | 69 2 | 123 8 | 260 8 | 405 6 | 335 2 | 198 8 | 453 9 |
| <i>Percentage Distribution of Net Total</i> | | | | | | | | |
| General government | 7 5 | 8 9 | 6 7 | 6 8 | 7 2 | 7 4 | 7 4 | |
| Public safety | 19 5 | 16 9 | 15 2 | 14 7 | 14 7 | 15 6 | 14 6 | |
| Health, sanitation | 11 6 | 11 8 | 11 5 | 11 1 | 11 3 | 9 0 | 8 2 | |
| Streets | 22 4 | 21 5 | 17 3 | 20 2 | 20 8 | 10 1 | 10 5 | |
| Social welfare and corrections | 7 1 | 5 4 | 4 7 | 5 8 | 6 3 | 17 9 | 21 1 | |
| Education | 25 6 | 26 5 | 37 4 | 33 4 | 31 3 | 28 8 | 29 6 | |
| Recreation | 4 9 | 6 1 | 4 0 | 4 2 | 4 4 | 4 6 | 3 8 | |
| Miscellaneous | 1 4 | 2 9 | 3 2 | 3 8 | 4 0 | 6 6 | 4 9 | |
| Net total .. | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | |
| Capital expenditure | 31 5 | 30 3 | 28 5 | 29 6 | 30 1 | 11 5 | 15 2 | |

¹ Cities with populations over 30,000. 154 in 1905, 199 in 1913, 248 in 1923, 310 in 1930

² Cities with populations over 100,000. 94

Derived from United States Bureau of the Census. *Financial Statistics of Cities* series.

Between 1905 and 1930 the functional distribution of city expenditure changed very slightly. School expenditures increased more rapidly and street construction expenditures less rapidly than other classes of city outlays between 1905 and 1923, but these tendencies reversed themselves during the next seven years. Capital outlays accounted for three-tenths of all city expenditure more or less throughout this period.

From 1930 to 1934, if the experience of the ninety-four cities whose populations exceed 100,000 is any guide, the construction of streets and schools fell off abruptly. With one marked exception, all maintenance expenditures were considerably reduced. Relief and other charitable payments mounted, so rapidly in many municipalities as to threaten their very solvency.

Some of these developments were but temporary phenomena of the recession. Between 1934 and 1938 there was a general increase of all phases of city expenditure. In most instances, the high levels of expenditures on various functions that marked the close of the 1920's were not reattained. Often enough, this meant that after a space of years, a city was rendering the same or even greater services at lower costs made possible by the decline in prices; in some cases, however, depression economies resulted in a continuing cut in the scope of municipal services undertaken. One development worthy of notice is the continued expansion of municipal expenditures for relief and other forms of social welfare, in spite of the assumption of many welfare functions during this period by the federal and state governments. From 1934 to 1938, this category of municipal expenditure increased more rapidly than any other. Also significant, for this group of cities with populations over 100,000, is the absolute decline in interest payments from \$353,000,000 in 1934 to \$207,000,000 in 1938, indicating that during this period old municipal debt was retired more rapidly than new was incurred, and also that favorable refundings may have occurred in some instances.

Counties

Variety in size, population, and functions of counties is extraordinarily great. Obviously, Cochrane County in Texas with its 70

inhabitants and Cook County in Illinois with its 3,000,000 are similar only in name. New England counties are little more than judicial districts. Elsewhere in the country counties are vital administration units—they support schools, build roads, maintain hospitals, asylums, and jails, and coordinate and supervise the administrative and fiscal activities of the smaller governmental units within their

TABLE 9
PURPOSES OF COUNTY EXPENDITURE,
1902, 1913, AND 1932

| Purpose of Disbursement | 1902 | 1913 | 1932 |
|---|-----------|-----------|-----------|
| <i>Amounts (in thousands)</i> | | | |
| General government | \$ 71,441 | \$102,335 | \$251,150 |
| Protection to person and property | 7,298 | 15,213 | 44,231 |
| Health, sanitation | 1,899 | 2,815 | 32,778 |
| Highways | 28,522 | 55,515 | 236,350 |
| Social welfare and corrections | 20,404 | 37,815 | 182,120 |
| Education | 34,096 | 58,047 | 182,178 |
| Recreation | | 420 | 7,618 |
| Miscellaneous | 2,253 | 5,575 | 44,767 |
| Total current service expenditure | \$165,913 | \$277,735 | \$981,192 |
| Interest | 9,613 | 17,418 | 118,875 |
| Capital outlays | 21,839 | 89,840 | 311,270 |
| Public utilities | | 189 | 489 |
| <i>Percentage Distribution of Current Service Expenditure</i> | | | |
| General government | 43 1 | 36 8 | 25 6 |
| Protection to person and property | 4 4 | 5 5 | 4 5 |
| Health, sanitation | 1 0 | 1 0 | 3 4 |
| Highways | 17 2 | 20 0 | 24 1 |
| Social welfare and corrections | 12 3 | 13 6 | 18 5 |
| Education | 20 6 | 20 9 | 18 5 |
| Recreation | | 2 | 8 |
| Miscellaneous | 1 4 | 2 0 | 4 6 |
| Total | 100 0 | 100 0 | 100 0 |

Derived from United States Bureau of the Census, *Wealth, Debt and Taxation*, 1902 and 1913, and *Financial Statistics of State and Local Governments*, 1932.

concentrated settlements in sparsely settled areas, and (2) super-districts, covering areas of two or more regular governmental units, which administer a centralized service—multitown fire or water supply, for example—more efficiently and more cheaply than could the individual units. To illustrate the extent of special district development in recent years, New York in 1932 had 934 lighting districts, 492 fire districts, and 1045 other districts providing police protection, water, hydrant, sewage, and drainage systems, refuse and garbage collection, street, sidewalk, and paving improvement, park maintenance, and miscellaneous joint functions. Their tax and special assessment levies totaled \$17,000,000, and they had \$89,000,000 of debt outstanding.

While special districts have existed in some states almost as long as the states themselves, their widespread development is a comparatively recent development. Information as to their activities, and machinery for their effective control, are both lacking.

EXPENDITURE FOR PUBLIC EDUCATION ⁴

The tradition of a free, generous public school system is one of the most cherished elements of our American civilization. It was a revolutionary concept when introduced by the colony of Massachusetts in the middle of the seventeenth century. General popular recognition of the value of a free educational system, particularly the extension of such a system to include free secondary schools, was slow in developing, and not until the middle of the nineteenth century could the tradition be said to have been definitely established as part of the American way of life.

Growth

In 1870, the earliest year for which we have statistics on public education expenditures, they amounted to \$63,000,000. Twenty years later the figure was \$141,000,000. In 1930, the cost of public school education to the United States was \$2,317,000,000, and it constituted

⁴ The most comprehensive recent study on this subject is Paul R. Mort and Walter C. Reusser, *Public School Finance* (McGraw-Hill Book Co., New York, 1941).

the most important function of American government. Various factors contributed to this tremendous growth.

As between 1890 and 1930, a rising price level was an important consideration. Were school expenditures in the two years reduced to a common price basis, and expressed in 1913 dollars,⁵ the total for 1890 would be \$175,633,000 and that for 1930, \$1,379,045,000. Clearly, over two-fifths of the apparent increase in school expenditures resulted from the decline in the value of the dollar during this period.

Increased school attendance also contributed to the growth in school expenditures. Not only did the actual number of children of school age increase from 18,543,201 in 1890 to 31,571,322 in 1930, but the proportion of children enrolled in schools rose from 68.6 per cent to 81.3 per cent; as a consequence, school enrollment more than doubled. Moreover, the proportion of daily absences decreased markedly; of the children enrolled in 1930, 82.8 per cent were in attendance each day, as compared with 64.1 per cent in 1890. Improved school attendance alone has necessitated the provision of greater facilities. And some additional factors, all of which involve increased school costs, have yet to be noted. From an average length of 134.7 days in 1890, the school year increased to 172.7 days in 1930. For the United States as a whole, the total number of school days for all pupils⁶ more than tripled in this period. And the school day itself has been lengthened appreciably. When the increase in school costs attributable to the rising price level is eliminated, the growth in the bare physical requirements of education is shown to be responsible for more than two-thirds of the remaining increase.

Allowing for price changes and the increased quantity of education purveyed, the "true" cost of education in the United States barely doubled between 1890 and 1930. This doubling in true costs represents an improvement in the quality of public education, rather than inefficient and extravagant misuse of public funds by school administrators. One contributing factor has been the disproportionate growth in high school attendance. In 1890 high school

⁵ The Snyder revised general price level index was used to calculate school expenditures on a "1913 dollar" basis.

⁶ Computed by multiplying the number of days in the average school year by total pupil attendance.

pupils represented 16 per cent of the total school enrollment; in 1930 the proportion was 17.1 per cent. Since the cost per high school pupil per day is approximately two-and-a-half times greater than that of a grammar school pupil, no small share in the rising cost of American public education may be attributed to the growing interest in higher education.

TABLE 10
FACTORS IN PUBLIC SCHOOL EXPENDITURE,
SELECTED YEARS 1870-1938

| Items | 1870 | 1890 | 1910 | 1920 | 1930 | 1938 |
|---|---------|---------|---------|-----------|-----------|-----------|
| <i>Children 5 to 17 years of age</i> | | | | | | |
| Number ¹ | 12 1 | 18 5 | 24 2 | 27 7 | 31 6 | 30 8 |
| Per cent of population | 31% | 30% | 26% | 26% | 26% | 24% |
| <i>Pupils enrolled</i> | | | | | | |
| Number ¹ | 6 9 | 12 7 | 17 8 | 21 6 | 25 7 | 26 0 |
| Per cent of children 5 to 17 | 57% | 69% | 73% | 78% | 81% | 84% |
| <i>High school students</i> | | | | | | |
| Number ¹ | 1 | 2 | 9 | 2 2 | 4 4 | 6 2 |
| Per cent of pupils enrolled | 1% | 2% | 5% | 10% | 17% | 24% |
| School term (days) | 132 | 135 | 158 | 162 | 173 | 174 |
| Average days attended | 78 | 86 | 113 | 121 | 143 | 149 |
| Average daily attendance ¹ ... | 4 1 | 8 2 | 12 8 | 16 1 | 21 3 | 22 3 |
| Total days attended ¹ | 539 1 | 1,098 2 | 2,011 5 | 2,615 2 | 3,672 8 | 3,876 6 |
| Total expenditures ¹ | \$63 4 | \$140 5 | \$426 3 | \$1,036 2 | \$2,316 8 | \$2,233 1 |
| Expenditures per capita | \$1 64 | \$2 24 | \$4 64 | \$9 80 | \$18 87 | \$18 15 |
| Expenditures per pupil | \$15 55 | \$17 23 | \$33 23 | \$64 16 | \$108 49 | \$99 70 |
| Expenditures per pupil day | \$0 12 | \$0 13 | \$0 21 | \$0 40 | \$0 63 | \$0 57 |
| Average teacher's salary .. | \$189 | \$252 | \$485 | \$871 | \$1,420 | \$1,374 |

¹ In millions

Derived from United States Bureau of Education, *State School Systems, 1938*.

Moreover, teachers today, because they are of higher caliber and have better training than those of a generation ago, must be paid higher salaries. In 1890 the average annual salary for teachers throughout the United States was \$252. In 1930 teachers were paid an average of \$1420 per year. Although part of this salary increase has been due to the increased cost of living, the greater part represents a "true" advance in the levels of teachers' salaries.

Costly modern buildings and equipment have replaced the antiquated schools. To enable rural children to share the educational opportunities of urban children they are collected by school buses

and transported to town and city schools. The old academic program has been augmented by such extracurricular activities as athletics, music, art, and dramatics, by vocational courses in typewriting and stenography, dressmaking and cooking, woodworking, metalcraft, and printing, and by courses in business methods and economic geography. Subnormal children and other distinctive groups are given special training. All these factors which contribute to improved education—better and higher-salaried teachers, improved buildings, more specialized equipment, special courses—share the responsibility for doubling the “true” costs of public education in the United States between 1890 and 1930.

The persistent increase of school expenditure ceased in the 1930's. One reason was the recession. From 1930 to 1934, teachers and other school employees took salary cuts. Purchases of supplies and costs of maintaining school property were held to a minimum. But penny-shaving economies alone could not balance the decline in school revenues. Teachers' class loads were increased, special courses were eliminated, school terms were cut. In some instances, schools had to be closed for lack of funds. Between 1930 and 1934, total school expenditures were reduced by \$600,000,000—over 25 per cent. During the second half of the decade, some of the ground lost was recovered. Teacher salary cuts were restored in part, excessive teaching loads were relieved, and extreme economies were relaxed. All measures of educational expenditure increased over the lows registered for 1934, but did not return to the level of 1930.

But a new education development appeared in the 1930's. *For the country as a whole, the school population stopped increasing.* The number of children in the “school age” range, 5 to 17 years, reached a peak of 32,400,000 in 1934, then started to decline; in 1938 it was 30,800,000. The figure for children actually enrolled in school after 1930 was temporarily stabilized around 26,000,000. This ending of the expansion of the school population came as no surprise to the school authorities. It had long been forecast by the population statisticians as a consequence of the shrinkage of immigration and the decline of the American birth rate; it had been foreshadowed in edu-

cational statistics by the earlier persistent decline in the annual increase of school population. Now, for the country as a whole, school expansion to meet an expanding child population was a thing of the past. Of course, the development was not uniform for the entire country. There were still states and there were still communities where school attendance was increasing, but these were balanced by other states and communities where the number of school pupils was declining. The first group of states and communities would still have to increase their school facilities to accommodate an increasing number of children, while in the second group existing facilities would suffice. But, in general during the 1930's one of the most important factors in the expansion of educational expenditure was greatly weakened.

Financing public education

Public education in the United States has from the beginning been a local responsibility. State school funds, established by federal and state land grants and special money grants, which today would have been worth two billion dollars or more, were criminally mismanaged. Lands were sold for less than their real value, deeds were improperly recorded or not recorded at all, proceeds of land sales vanished without record, bad loans were made, officials absconded with funds. In few states did the local school districts receive any substantial benefit from these funds, and education remained, as it had begun, primarily a locally financed function.

About fifty years ago the system of local school finance began to break down. Divergence between the education needs and the taxable resources of individual districts became so pronounced as to demand rectification. A wealthy community might be able to provide extravagant educational facilities with a trifling school tax, while a confiscatory rate in a neighboring poor district would not finance the most meager of schoolings for its children. A modest beginning was made in granting state school aid to the weaker districts.

During the 1920's, a program for state equalization of educational opportunity replaced the casual and frequently ill-considered dis-

tribution of state school aid.⁷ State participation in education was further impelled by the financial difficulties of many local districts during the depression years of the 1930's. Educators developed a new standard for state school support—the state government should furnish, or guarantee through state aid, a minimum school program in all districts of the state. Local districts should be responsible only for supplements over this minimum.

Response to the appeal for state school funds has been varied. In 1938 the ratio of state funds to total state and local school revenues was 93 per cent in Delaware, 74 per cent in New Mexico, and 71 per cent in North Carolina. On the other hand, state funds were only 0.2 per cent of combined school revenues in Colorado and Oregon, and 0.9 per cent in Nebraska.

But even if equalization of educational opportunity were fairly and fully accomplished within each state, there would still remain the wide variance between states. A recent calculation, presented in Table 11, gives New York and Delaware seven times as much economic ability to support education as Mississippi.⁸ Another report points out⁹ that a defensible program of education in Mississippi would absorb the entire yield of an equitable tax system in that state, leaving nothing over for other governmental services; in Nevada, on the contrary, 17 per cent of the revenue from a tax system with reasonable rates would support a similar program. Primarily because of this disparity in financial capacity, and secondarily because of differences in the effort made to support school systems, educational accomplishments differ widely from state to state. Mississippi's current school expenditure per pupil attending school in 1938 was \$21.83; New York spent \$140.38.

Proposals that the federal government "do something" for education have long been rife. When school expenditures were cut 25 per cent during the depression of the early 30's, the movement was fur-

⁷ A fuller discussion of the problems of state school aid distribution is presented on pp. 737 ff. of this volume.

⁸ John K. and Margaret A. Norton, *Wealth, Children and Education* (Teachers College of Columbia University, New York, 1938), Ch. V

⁹ Paul Mort, *Federal Support for Public Education* (Teachers College of Columbia University, New York, 1936), p. 9.

ther vitalized. To put the school systems of the poorer states upon a parity with those of richer states, it was proposed that the federal government provide an annual "equalization fund" of at least \$300,000,000. Educators' associations built up considerable political sym-

TABLE 11

RELATIVE ABILITY, EFFORT, AND ADEQUACY OF SCHOOL SUPPORT BY STATES DURING THE 1930'S

(National average = 1.00)

| State | Ability | Effort | Adequacy | State | Ability | Effort | Adequacy |
|---------------|---------|--------|----------|----------------|---------|--------|----------|
| New York | 2.03 | .92 | 1.87 | Oregon | .85 | .88 | .74 |
| Delaware | 1.99 | .71 | 1.42 | Kansas | .81 | .88 | .72 |
| Rhode Island | 1.56 | .88 | 1.37 | Indiana | .81 | 1.10 | .89 |
| Nevada | 1.49 | .99 | 1.47 | South Dakota | .79 | 1.12 | .89 |
| Connecticut | 1.48 | .84 | 1.24 | Colorado | .76 | 1.27 | .97 |
| New Jersey | 1.48 | 1.08 | 1.60 | West Virginia | .75 | 1.20 | .90 |
| Massachusetts | 1.47 | .99 | 1.45 | Florida | .74 | 1.09 | .81 |
| New Hampshire | 1.37 | .88 | 1.20 | Texas | .73 | .92 | .67 |
| California | 1.33 | 1.13 | 1.50 | Idaho | .72 | 1.16 | .84 |
| Maryland | 1.24 | .85 | 1.06 | Virginia | .68 | .81 | .55 |
| Illinois | 1.15 | .96 | 1.09 | North Dakota | .67 | 1.08 | .72 |
| Pennsylvania | 1.12 | 1.05 | 1.17 | Arizona | .65 | 1.48 | .96 |
| Ohio | 1.06 | 1.06 | 1.12 | Oklahoma | .61 | .93 | .56 |
| Iowa | 1.05 | .84 | .88 | Louisiana | .58 | 1.10 | .64 |
| Missouri | .97 | .79 | .77 | Utah | .57 | 1.47 | .84 |
| Minnesota | .96 | 1.12 | 1.08 | Tennessee | .56 | .93 | .52 |
| Vermont | .95 | .96 | .91 | New Mexico | .53 | 1.55 | .82 |
| Wyoming | .95 | 1.18 | 1.12 | Kentucky | .53 | 1.12 | .60 |
| Michigan | .93 | 1.18 | 1.10 | North Carolina | .50 | .93 | .46 |
| Washington | .92 | 1.10 | 1.01 | Georgia | .45 | .99 | .45 |
| Wisconsin | .92 | 1.13 | 1.04 | Arkansas | .43 | .86 | .37 |
| Maine | .91 | .85 | .78 | South Carolina | .42 | 1.10 | .46 |
| Nebraska | .91 | .75 | .68 | Alabama | .38 | 1.15 | .44 |
| Montana | .91 | 1.15 | 1.05 | Mississippi | .31 | 1.36 | .42 |

From Norton and Norton, *Wealth, Children and Education*, pp. 74-75.

pathy for their cause. Some \$20,000,000 of federal emergency funds were used in 1934 and 1935 to maintain hard-pressed rural schools. Several bills providing for federal school aid have been introduced in Congress. A special advisory committee reported favorably in 1938 upon the proposal for federal school aid distributed to the states on a need basis.¹⁰ Development of the federal defense program has apparently shelved this project for the time being.

¹⁰ The Advisory Committee on Education, *Report* (Washington, 1938).

Probable trends in public school expenditure

Although the nation's school expenditures declined during the early 1930's, the phenomenon was short-lived. Such expenditures are again increasing, and all indications point to their continued rise.

One basic factor in the past growth of school expenditure—a constant increase in the number of children to be educated—will not be present in the future. As previously indicated, limited immigration and a declining birth rate have already halted the growth of the country's child population, and the future trend will probably be slightly downward. But, while the number of children of school age has been stabilized for the time being, the growth of school enrollment may still continue for some time, in spite of the check it received during the 1930's. There is reason to believe that instead of seeking work after grammar school graduation, more and more children will continue their education into the higher grammar school grades, will attend junior and senior high school. What is more, wide improvement has still to be made in the material features of the school systems of the southern states and other sections where rural teaching standards are still pitifully low. Many states have yet to achieve school systems satisfactory to critical judgment, and their legislatures are continuously pressed for more generous educational appropriations.

Until the past decade, educational progress was most noted in the city school systems. Since wealth was concentrated in the cities, and they were growing ever richer, a moderate school tax usually provided ample funds to maintain an effective city school system and to permit its continuous growth and improvement. Neither school attendance nor taxable ability was concentrated in the countryside, and rural schools lagged far behind. Moreover, many rural districts were so poverty-stricken that they could not, with their own resources, ever place their schools upon a par with urban schools. Improvement of rural education has been the major school problem of the past decade. In districts immediately adjoining towns and cities, the problem has been solved by abolishing the rural schools and transporting the children by motor to the neighboring town and city

schools Other local districts too poor to maintain adequate schools have been assisted through systems of "equalizing" state aid. Here is a field wherein major improvement may be accomplished during the coming years, for the small one-teacher school is not only inferior in the quality of education that it purveys, but involves excessive unit costs. Consolidation of one-room-school districts into larger units with provision for pupil transport will continue on a large scale, and this reform will have to be supplemented by further extension of equalization state aid to the poorer districts.

EXPENDITURE FOR HIGHWAYS AND ROADS

America's highway history falls into three chapters. The first chapter, that covering the period of the tollroads or turnpikes, began in the 1780's and ended in the 1840's. Corporations, chartered by the state governments, built roadways to connect leading towns, and charged tolls for their use. A few tollroads were constructed by states, and one—the Cumberland Road—by the federal government. On these tollroads moved practically all the overland commerce—itsself small in proportion to waterborne traffic—during the first half century of this country's history.

* Development of the railroads during the 1840's, added to the decline in revenues suffered by most of the tollroad companies during the 1837-1842 depression, ended the tollroad era. Railroads became the medium for through overland traffic, and roadways, constructed and maintained almost exclusively by local governmental units, became simply feeders to railway stations and water ports. Except in New England, such roadways were often little more than parallel wheel ruts through cleared passageways. Grading was rare. Surfacing was practically unknown, except through swamp stretches where corduroy log surfacing was employed.

The third era of our highway history began in the 1890's. Bicycling enthusiasts may have started the drive for improved roads, but it was the automobile that insured the creation of the public highway. Local governments at first, later the states, and still later the federal government, assumed the function of building and maintaining motor highways. Today over three million miles of public high-

ways and roads web the United States, and additions are being made continually. One-quarter of this mileage is surfaced with wear-resisting media. Thousands of miles of dirt roadways are surfaced and paved into highways each year. Paved and unpaved roadways are kept in repair. Constructing, surfacing, and paving highways, and keeping existing roads in proper repair, cost the state and local governments over a billion dollars annually.

Progress in highway construction

In 1904 there were slightly over two million miles of roadway in the United States, of which 153,530 miles were surfaced. More than 97 per cent of this surfaced mileage consisted of sand-clay, gravel, and water-bound macadam roads—all of them elementary and, from present-day viewpoints, unsatisfactory. A surfaced road not only makes automobile riding more pleasant and comfortable, but results in a distinct saving per car—a saving on tires, springs, and gasoline. As the number of automobiles using arterial highways increased from hundreds to thousands, and from thousands to tens of thousands, the states realized that millions of dollars spent on improving highways would save the motorists using the highways even more millions. Moreover, through motor vehicle license charges and motor vehicle fuel taxes, the motorists using the highways could be made to reimburse such expenditures.¹¹

The quarter of a century after 1904 saw the triumph of the automobile and with it a revolution in the highway system of the country. Total highway mileage in the United States increased from slightly over two million to more than three million miles between 1904 and 1925. Within these twenty years, half again as many miles of roadway were built as in the whole previous history of the country. Meanwhile an increasing proportion of the highway mileage was improved—straightened, graded, widened, and surfaced—to render it suitable for heavy motor traffic. Surfaced highway mileage mounted from 153,530 in 1904 to 693,559 in 1930, and to 1,328,000 in 1940. Whereas surfaced roadways had been but 7 per cent of total highway mileage in 1904, they were 24 per cent of the 1930 mileage,

¹¹ See Ch XXIII, pp. 573 ff. of this volume.

and 45 per cent of the 1940 mileage. Furthermore, there was steady improvement in the quality of the surfaced highways. Mileage of roads paved with durable concrete, brick, asphalt, or bituminous concrete more than doubled between 1930 and 1940, and the increase in surface-treated mileage during this decade was from 34,000 to 256,000.

TABLE 12

HIGHWAY MILEAGE IN THE UNITED STATES BY TYPES OF CONSTRUCTION, SELECTED YEARS 1904-1940

(Mileage in thousands)

| Year | Total | Surfaced Mileage | | | | | | |
|------|-------|------------------|--|--|---------------------------------|--------------------------|-------|-------|
| | | Total | Sand-clay, Gravel, and Water-bound Macadam | Surface-treated and Bituminous Macadam | Asphalt and Bituminous Concrete | Portland Cement Concrete | Brick | Other |
| 1904 | 2,151 | 154 | 150 | 3 | | | | 1 |
| 1909 | 2,200 | 190 | 187 | 1 | | | | 2 |
| 1914 | 2,446 | 257 | 226 | 14 | 1 | 2 | 2 | 13 |
| 1921 | 2,941 | 388 | 321 | 30 | 7 | 16 | 3 | 11 |
| 1925 | 3,006 | 521 | 413 | 54 | 11 | 38 | 5 | 1 |
| 1930 | 3,009 | 694 | 568 | 34 | 14 | 73 | 5 | 1 |
| 1940 | 2,965 | 1,328 | 881 | 256 | 191 | | | |

Derived from publications of the United States Bureau of Public Roads

Choice of road surfacing was at first largely haphazard, but the type of construction has gradually been related to the traffic load. When traffic can be sustained by a gravel surface, the construction of a paved road entails an unnecessary outlay of money. When traffic requires a paved surface, the construction of a gravel road is false economy, both because traffic needs are not met and because heavy traffic soon destroys gravel surface. Light parkway surfacing suitable for passenger vehicles crumbles under the pounding of heavy buses and trucks. The eight- and six-lane "superhighways," four-lane highways, three- and two-lane roads constructed today represent careful adjustment to motor traffic requirements.

Development of highway expenditure

Local governments bore the entire burden of constructing and maintaining public roads during the nineteenth century. They relied upon statute labor for much of the work involved. Instead of collecting taxes, and paying for hired road labor out of this revenue, freeholders were called upon to work for a specified number of days on the roads of their districts. At the appointed time they brought their plows, barrows, scrapers, and rollers, and in leisurely, neighborly fashion, put their local roads into condition for the season. As late as 1889, Kentucky, South Carolina, Georgia, Alabama, Mississippi, Louisiana, Nebraska, and Utah levied no taxes for road purposes. By 1904, the construction and maintenance of roads and highways was universally being financed either by property taxes or by labor obligations payable in cash, but in many cases labor and cash were more or less interchangeable. The cheapness of constructing and maintaining dirt roads, and the continued use of statute labor, kept the highway bill of the country at a low figure. It is doubtful if the total of all road and highway expenditures exceeded \$80,000,000 in 1904.

Highway expenditures mounted rapidly with the building of the surfaced roads required by automobile traffic. In 1914 the state and local governments spent about \$240,000,000 on highways. In 1929 their highway bill approximated \$1,800,000,000. During the 1930's it varied between \$1,000,000,000 and \$1,500,000,000.

But building arterial primary roads for interurban traffic, a task which involved expensive grading and surfacing, transcended both the duty and capacity of local governments. At first the states believed they could solve the problem of constructing and maintaining adequate trunk highways by supplying state aid—supplementing local highway appropriations by state funds, and permitting local units to spend the combined amount. New Jersey provided a system of state road aid in 1891, and Massachusetts did likewise in 1892.¹² Even under state aid systems, however, the local construction of primary roads led to piecemeal and uncoordinated highway build-

¹² Fuller consideration is given to the problem of state road aid on p. 735 of this volume.

ing. Width, surfacing, and solidity of arterial highways would change at each county or town border, with consequent reduction of the utility of the highways as media of through travel. The state governments themselves then undertook the construction and maintenance of arterial highways and main market roads. Massachusetts was the first to initiate such a program of state highway activity. With the growth of motor traffic, state highway control spread rapidly, and an increasing mileage of roadways was incorporated into the state systems; in 1940 nearly one-seventh of the country's 2,965,000 miles of roadway were state highways, and another substantial fraction of county roads was state-controlled.

When in 1916 the federal government began to contribute toward highway construction, it limited its appropriations to the improvement of post roads. Federal highway aid subsequently came to be viewed as a major factor in developing a continental system of motor highways rather than a minor expenditure to aid the postal service.

In 1904 state contribution to highway construction and maintenance was negligible; such activity was still almost exclusively a local function. By 1921, when comparable statistics are again available, the state governments were spending 46 per cent of the \$622,000,000 devoted to highway construction. In 1930 the states spent nearly two and a half times as much as the local units on highway construction, and, inclusive of state aid, were responsible for 60 per cent of the \$1,570,000,000 total expenditure on highways and roads. The proportion of state highway expenditure to the combined state and local total in recent years has been close to 65 per cent.

Probable trends in highway expenditure

During the quarter century in which the construction and maintenance of roadways changed from a local function to one shared by the state and local governments, state highway expenditures increased much more rapidly than local highway expenditures. But it cannot be expected that roadway construction and maintenance will evolve into an exclusive state function. Roads serving purely local needs should be financed out of local revenues obtained either from

general tax revenues or from special assessments on adjoining land. Should a particular road lose its local character by being improved and absorbed into the state highway system, its improvement and subsequent maintenance should, of course, be financed out of state funds. Such evolution of local into state roads, with a consequent reduction of local highway costs and increase of state highway costs, is already largely completed. In all but a few states, the roads now maintained by local governments will probably continue to be so maintained.

Except during the war years and the depression years of the early 1930's, state and local highway expenditure has increased steadily. The amount of additional mileage surfaced and constructed increased each year. Highway construction cannot, of course, continue forever on an increasing scale. Some of the Eastern states, which early inaugurated comprehensive programs of highway construction, have already brought them to completion. While they still add to their total highway or improved roadway mileage, such new construction is on a declining scale. Their major efforts are shifting from highway construction to highway maintenance. But many of the states, their highway programs still far from completion, are bending their efforts toward more construction. National defense demands may interfere with these state highway programs in the immediate future. Afterward, there may be a postwar spurt in highway construction in some states to catch up with delayed programs. But the long-run tendency for the future would appear to be a decline in highway construction expenditure.

Meanwhile, for every surfaced road built, some government is committed to a future program of maintenance and repair. In general, the more expensive hard-surfaced roads necessitated by heavy automobile traffic cost most to keep in constant repair. Maintenance and repair lag several years behind construction costs, but once they begin, they are long-continuing. And as a road grows older, the cost of maintaining it mounts, until it becomes more practicable to lay a new road than to keep the old one in repair. Clearly, state and local expenditures to maintain and repair roads and bridges will continue to increase for a long time to come.

SOCIAL WELFARE EXPENDITURE

Prior to the 1929-1933 recession, "charity" was looked upon as a field for the exercise of private virtue rather than as a major governmental function. None the less, a growing part of the burden of social relief was borne by governmental agencies during the two decades preceding the economic collapse of the 1930's. These earlier social welfare expenditures of American governments consisted primarily of "indoor relief" of the extreme poor—the provision of "poor houses" by local governmental units. Some states authorized their local units to provide a limited amount of "outdoor relief"—money allowances or grants of food and clothing to needy individuals or families living in their own homes. These local "relief" expenditures, however, barely scratched the surface of the social problem, even in its milder form during the 1920's.

Social welfare expenditures by the state governments was on an even more limited scale, and was directed to more specialized objectives. The states made appropriations for institutional care of "categorical" groups, such as the insane, the blind, the crippled, the deaf and dumb, and other defectives. During the 1920's there was some development of state expenditure for mothers' aid and assistance to dependent children, generally in the form of state grants-in-aid.

Federal contributions to social welfare prior to the 1930's were indirect. No less than 21 federal departments, offices and bureaus in 1929 were interested some way or other in the nation's social work. Of these, the Children's Bureau, created in 1912, was the only one engaged exclusively in some field of welfare work.

Emergency relief, 1930-1935

The tide of misery that flowed in the wake of increasing unemployment after 1929 overwhelmed the private charities and soon outran the relief capacities of local governmental units hamstrung by declining tax collections and weakened credit standing. Public opinion swung to the view that the meeting of this social emergency was a governmental obligation. New York was the first state to adapt itself to the new order. In September 1931 it created a Tem-

porary Emergency Relief Administration and granted it an initial \$20,000,000 to be expended as state aid for unemployment relief. New Jersey in October 1931, and Pennsylvania a month later, took similar steps. By 1933, more than half of the states were expending state funds in substantial amounts on depression relief.

Pressure for federal relief appropriations began in 1931, and produced the provision of the Emergency Relief and Construction Act of July 1932 for RFC advances to the states to assist them in furnishing relief and "work relief." Pressure for direct relief expenditure by the federal government continued as the recession continued, and culminated in the Federal Emergency Relief Act of May 1933, which established relief expenditure as a major federal function for the next half decade.

As previously described,¹⁸ the federal emergency relief program embraced two divergent elements—grants-in-aid to state and local units for their relief work, and "work relief" appropriations to provide temporarily for unemployed "employables." A tremendous and increasing burden of emergency relief was still borne by the localities and the states. Local relief expenditures were \$200,000,000 in 1933, \$250,000,000 in 1935. State relief expenditures were over \$100,000,000 in 1933, and doubled in the next two years. In all, the state and local governments spent \$1,200,000,000 on relief during the three-year period 1933 through 1935, against the \$2,900,000,000 expended by the federal government.

By 1935, the state and local "poor relief" and "categorical relief" programs which had carried over from the 1920's were overshadowed by their "emergency relief" expenditures; to a considerable extent, indeed, the former had been absorbed in the latter. The emergency program was admittedly temporary. But it had made the country conscious, as never before, of the social insecurity that forever faced millions of citizens, and it had won popular acceptance of the view that substantial prevention and mitigation of social insecurity are proper governmental functions. In 1935 the emergency relief activities of the federal and state governments were largely discon-

¹⁸ See pp 74-76 of this volume.

tinued; a permanent, federal-sponsored "social security" program replaced them.

Social security since 1935

The Social Security Act of 1935 provided for both prevention and mitigation of social insecurity. Its "preventive" features were two—the federal old-age pension financed by payroll taxes collected from employers and employees,¹⁴ and the unemployment insurance systems financed by employers' payroll taxes and administered by the states.¹⁵ The old-age pension system, once it is in full operation and maximum pensions are being paid, will eliminate much of the necessity for providing state and local relief for the "aged poor." State unemployment insurance systems, similarly, will soften the hardships resulting from loss of employment and reduce the calls made upon local governments for poor relief.

Mitigation of social insecurity under the Act of 1935 was accomplished by provision for federal grants-in-aid to the states for old-age relief not covered by the pension law, for child aid, and for other forms of "categorical" relief, provided that the states themselves made suitable provision for these classes of relief. Every state except Virginia had its legislature in session during 1935, and there was a spate of law-passing to bring state relief functions into conformity with the requirements of the new federal law. Much of this initial legislation was ill-considered, and has subsequently been radically changed. As amended, the social security laws of the states now provide a permanent system of broad relief expenditure.¹⁶

Probable developments

High, incredibly high, as current social expenditures appear to those whose standards were established in the 1920's, it is probable that this category of governmental expenditure will expand in the future. Now that responsibility for social unfortunates has been popularly accepted as a governmental function, the problem arises of the

¹⁴ Described on pp. 465 and 532 of this volume

¹⁵ Described on p. 82 of this volume.

¹⁶ Current state social security expenditures were discussed on pp. 82-83 of this volume

standards of the aid to be given. It is not enough to give some aid to widows and dependent children, to the aged, and to other categories of those who need public assistance, they must be given *sufficient* aid. There can be no absolute standards of the sufficiency of relief allowances of various sorts, any more than there can be absolute standards of provision for public education or for police protection. But just as standards for all other public functions have risen with the years, so it is certain that there will be continuing pressure in the many states and communities whose social welfare programs at present are behind the country's average to expand these programs. The federal defense program initiated in 1940 may for a while check the expansion of social welfare expenditure, both because the economic prosperity which it induces cuts the need for certain categories of relief, and because its claim upon public funds will leave no room for expansion of other functions. But unless the defense program works an unforeseen economic and social revolution, this check cannot be more than temporary.

A second reason for expecting that social welfare expenditures will increase in the future is the invitation that this function offers to the formation of pressure-groups of recipients of the public bounty. Already the legions of the aged have been marshaled in support of the Townsend Plan and other proposals for expanded pensions for the aged; in Colorado, at least, their influence has been strong enough to commit the state to an old-age pension program all out of proportion to the financial resources of the state government. Efforts have been made to promote "Widows' Leagues" in some of the states to campaign for larger allowances for widows. A tremendous urge of self-interest motivates the participants in such pressure groups, yet they are able to appeal to legislatures and the voting public under the holy banner of altruistic ideal. In all probability, these social beneficiary pressure groups will fall far short of attaining the bounties they demand but, equally probably, their efforts will have some influence in expanding public relief payments of various types.

CHAPTER V

Economy and Control in Governmental Expenditure

CRITICS commonly denounce governmental activity as extravagant, wasteful, honeycombed with graft. It is, of course—but so is private enterprise. And the planes on which government and private enterprise operate are in many respects so widely separated that no standards of comparison are available.

The nearest we have to an impartial survey of the issue is the report of a commission of inquiry appointed by the Social Science Research Council.¹ That commission reached the indeterminate conclusion that private business at its best is more efficient than the average government, but that government at its best is more efficient than the average business enterprise. Testimony at many of the hearings ran fifty-fifty—what private business gains through the profit incentive and elasticity it loses through hereditary management, labor difficulties, and outside control. Moreover, “in America, governments have, as a rule, undertaken no services except after private agencies have proved themselves incapable or powerless to conduct them”—in short, until they became nobody’s business. “To achieve any measure of success under such conditions is a remarkable accomplishment for public management.”

A noncommittal conclusion that the conduct of government business is no worse than that of private business is hardly basis for self-satisfaction and acquiescence in the *status quo*. Governmental extravagance must be held in check. Governmental waste and graft must be reduced, even if they cannot be altogether eliminated.

Tremendous steps have been taken during the past quarter century toward increasing the efficiency of American government.

¹ Social Science Research Council, Commission of Inquiry on Public Service Personnel *Better Government Personnel* (McGraw-Hill Book Co., New York, 1935), p. 21.

And the accomplishments thus far indicate the direction of future improvement. Most promising opportunities for economy and efficiency in government appear to be: (1) reorganization of governmental structure to encompass the best distribution of functions between state and local units, and to improve the administrative setup of individual units; (2) specific administrative reforms—central purchasing, better personnel management, and sounder custody of public funds; (3) improvement of budgetary procedure; (4) central supervision or control of local functions and finances; and (5) “pressure group” organization by taxpayers to cultivate public economy and efficiency.

GOVERNMENTAL REORGANIZATION

Governments grow like old English houses—a wing added here, an extension there, up-to-date plumbing put into this section, another shut off and allowed quietly to crumble away. Such growth is picturesque rather than efficient, and in government the results are overlapping duties, divided responsibility. Eventually, so patent does the inefficiency of government operations become that pressure for reform overcomes even the inertia of public officials for any form of administrative housecleaning, and the administrative machinery is reorganized.

Redistribution of functions among governmental units

Each of the 175,000 governmental units in the United States performs one or more functions. Any inquiry into governmental efficiency should begin with the query, “Is the present distribution of functions among these governments the most effective and economical that could be planned?” The answer would be “No.”

Take the case of the town and the township. This unit was developed in colonial New England to govern a village and its surrounding territory, and it served well the rudimentary governmental needs of that frontier society. As New Englanders migrated westward, they carried with them the township government. And so it has persisted, in twenty-three states, into the present century. But today, outside the New England states, it is an artificial unit, fre-

quently without a population center, and fitted for no good governmental purpose. It is too small for efficient handling of road maintenance, poor relief, and property tax administration—functions usually assigned to it. Its officials usually devote only part-time attention to their governmental duties, and the town functions are accomplished in hit-or-miss fashion. Grave inequalities in taxable resources exist as between small units such as towns, and their services and tax rate vary accordingly. In most states, were town functions shifted to the counties or to the state government, they would be better and much more cheaply administered, and their costs would be more fairly distributed.

Is the present setup of school districts the most efficient organization for purveying education? So deeply rooted is the school district in the established pattern of American life, that to some readers merely raising this question may savor of heresy. Yet many educators are urging planned reorganization and consolidation of the school districts in each state, and some would replace the local districts by county school units. With improvement in transportation facilities, they argue, the radius of school attendance has far exceeded the limits which originally determined the areas of most school districts. In many instances, fewer and larger school units could supply better educational facilities and at the same time lower the cost to the taxpayers. Not long ago, one authority estimated that the number of school districts in the United States could profitably be reduced from 127,000 to 27,000.² Within two years, as a result of a school survey made in 1929-1930, Arkansas eliminated 1216 local school districts by consolidation. Eleven states, ten of them in the South, where problems of school finance are most pressing, have already replaced local school districts with county school units; other states have shown interest in the proposal.

County organization has been much criticized in recent years. Through consolidation, small or sparsely settled counties in many states could cut their costs of government substantially, but political considerations so far have blocked most efforts toward such consoli-

² William G. Carr, *School Finance* (School Economy Series, Publication No. 7, Stanford University Press, 1933), p. 78.

dition. The state or special districts, it is argued, could handle much more economically traditional county functions like road maintenance, drainage, and poor relief. On the other hand, some new activities—the maintenance of airports, the administration of certain elements of agricultural aid—might be better managed by the counties than by the governmental units now carrying them.

Special districts of all sorts have been casually and carelessly established to handle particular functions. Too often the motive has been avoidance of tax or debt limits which hampered pre-existing governmental units in expanding their activities. Within the area of the city of Chicago, twenty-eight overlapping and superimposed districts perform public functions and levy taxes. One authority has denounced this Chicago conglomeration as follows:

This complex of political units under which an attempt is made to provide public services involves every conceivable type of waste. The duplication of services which is obviously involved is less serious than the inability properly to perform certain functions or to determine what services are wanted or which should be provided. The maintenance of uniform, standardized or coordinated service is impossible. Some areas are occupied by so many political units that the services can not be properly dovetailed; others have so few people that it is a form of economic folly for them to maintain separate or independent units of government, some have such small territorial dimensions that they should certainly be attached to other units. The lack of size or population in many subdivisions prevents efficient management, renders impossible the economical expenditure of funds or the wise acquisition of public property, makes difficult the employment of competent personnel, aggravates the problem of adequate financing and impedes the coordination of services in a single territory. On the other hand, the multiplicity of territorial units tends to increase the number and variety of political party organizations, spoils, jobs, and graft, especially if the many territorial units are supplemented by overlapping and duplicating functional or ad hoc agencies. This condition not only increases waste by the loss through duplication of services, personnel, equipment and public property, but prevents coordinated planning, the establishment of accepted standards of service, and the proper apportionment, control and budgeting of public funds. It maximizes political irre-

sponsibility, makes it impossible for the electorate wisely to select its officials, contributing in every possible way to the development of machine-controlled politics, corruption, and inefficiency.³

Tempered slightly, this condemnation could apply to special district setups in many parts of the country.

The framework of our state and local governmental system was not planned. It just grew. Because of this planlessness, millions of dollars—literally—of public funds are wasted every year. But no single formula—a general shifting of town and village functions to counties, a transfer of county and other local functions to the state, a uniform creation of special districts of one type or another—will cure the evil. In most cases, further centralization of activities and responsibilities is indicated, in spite of the plea for “local home rule” made by the vested interests of local misrule, but centralization alone is not a panacea. For every state, and possibly for the individual regions within the states, the governmental units best fitted to administer the functions in question must be determined separately on the basis of public services rendered, area and population to be served, and taxable resources.⁴

Although to determine what organization of governmental units will handle public functions most efficiently is a supremely difficult undertaking, it is frequently only a minor first step toward effecting reform. Political parties and individual officeholders who feel that they have a vested interest in the current political structure, will oppose reorganization with all the influence at their command. And in public inertia and indifference to the drab appeal of economy or efficiency, they have a powerful ally. A sweeping plan for the general reorganization of local government in any state would prick so many private interests and rouse so many personal enemies that despite, or more probably, because of its merits, it would certainly be defeated in the legislature or at the polls. Authorities experienced

³ Simeon Leland, “Waste through Multiplicity of Governmental Units,” *National Tax Association Bulletin*, Vol. XII, 1937; pp. 163-164.

⁴ On some of the problems to be considered, see Harley L. Lutz, “Reallocation of Functional Responsibilities and Reorganization of Governmental Structure as Measures for Securing Greater Economy in Local Government,” in *Current Problems in Public Finance* (Commerce Clearing House, Chicago, 1933), pp. 81 ff.

in piloting governmental reform measures advise a "go slow" policy. Proponents of reform, their ultimate goal clearly in mind, should accomplish their program piecemeal—one part this year, one part next—choosing the most favorable course of campaign and keeping their enemies well divided.

Administrative reorganization of state government

State governmental functions changed little during the nineteenth century, and the machinery of state government which had been adequate at the beginning of the century was still effective at its close. But the expansion of state activities and functions, which began at the turn of the century and has since continued without interruption, strained the antiquated state administrative organization. Pressure for administrative reorganization in the interest of greater efficiency and economy grew more intense. In Illinois this movement culminated in the "civil administrative code" of 1917. The Illinois reorganization proved to be but the first of a long series. In all, twenty-three states have cleaned administrative house in the past quarter century.

A nationally recognized authority has stated the principles and aims of state administrative reorganization to be:

- 1 **Functional departmentalization of administrative agencies.** All offices, boards, commissions, and agencies of the state government should be consolidated and integrated in a few orderly departments. Each department should comprehend some major function of the government—finance, agriculture, public welfare, or public works. The number and character of the departments should be determined by the conditions within the state government and the scope of its existing activities. However, the total number of departments in any state government ought not to exceed twelve or fifteen. Closely related work within each department should be grouped under appropriate bureaus and divisions

- 2 **Fixed and definite lines of responsibility for all departmental work.** Each department should be headed by a single officer appointed and removable by the governor. This arrangement places the responsibility for the administrative work of the government beyond question, and makes the governor in fact, as well as in theory, the responsible chief executive of the state. The

department heads should constitute a cabinet to advise with the governor in matters of administration and to assist him in budgeting. Responsibility for the work of each bureau or division should be placed on a single officer directly accountable to the head of the department. The bureau heads should, as a general rule, be appointed by the department heads under whom they work.

3. **Proper coordination of the terms of office of administrative officials.** The governor's term of office should be at least four years; those of the department heads, if they are to be definitely fixed, should be carefully adjusted with reference to that of the governor. Department heads should not have terms longer than that of the governor. It seems preferable to have them serve at the governor's pleasure. This exception may be made, however, members of boards performing quasi-legislative, quasi-judicial, inspectional, or advisory functions either under departments or otherwise may be appointed for terms longer than that of the governor.

4 **Boards are undesirable as purely administrative agencies.** In this capacity, boards are generally found inefficient owing to division of powers and absence of initiative and responsibility. Ex officio boards are almost never effective. Whenever there are quasi-legislative, quasi-judicial, advisory, or inspectional functions within a department, a board may with advantage be attached to the department to perform such functions.⁵

To these four fundamentals of state administrative reorganization might be added a fifth—the strengthening of executive responsibility and control over state finances through the creation of a staff agency—a budget director, a “board of control,” or an “economy and efficiency commission.” Such an agency, besides preparing the state budget, may exercise some control over the fiscal procedure of the other state departments to ensure more effective execution of the budget.⁶

The twenty-six state reorganizations so far effected have not all followed the principles indicated above. Where the reorganization

⁵ Arthur E. Buck, *Administrative Consolidation in State Governments* (National Municipal League Technical Pamphlet No. 4, New York, 1928), pp. 5, 6, essentially the same statement of objectives is made, though in a less quotable form, in the same author's *The Reorganization of State Governments in the United States* (Columbia University Press, New York, 1938).

⁶ See pp. 142 ff. of this volume.

was accomplished by constitutional amendment, so that it could extend to the entire structure of state government, as in New York and Virginia, a well-integrated structure of government was established with responsibility centering upon the governor. Some of the statutory reorganizations, able to touch only partially the prerogatives of constitutionally elected administrative officials, could accomplish only a partial integration of organization and responsibilities; the reorganizations in Illinois, California, Idaho, Kentucky, Ohio, Pennsylvania, Rhode Island, and Washington fall into this category. A still lower form of statutory reorganization is found in Colorado and Indiana, where the elected administrative officials remain co-executives, though of inferior grade, with the governor, with independent and uncoordinated administrative departments under them. In several states—Connecticut, Maine, North Carolina, South Dakota, and Wisconsin—statutory reorganization went no further than centralizing such fiscal procedures as budgeting, general accounting, expenditure control, centralized purchasing, and sometimes personnel supervision under the governor.

Results of reorganization of state government are not always easy to ascertain, since resulting economies depend to a considerable extent on the attitude of the succeeding administration. But such analyses as have been made indicate that each of these reorganizations has saved the taxpayers of the state involved sums running from hundreds of thousands of dollars to millions of dollars a year.⁷

Administrative reorganization of local government

In the field of municipal government, the reform movement has taken the form of a campaign to substitute the commission and city-manager types of city government for the mayor-council type.

Characteristic of the commission form of city government is the commission of three, five, or seven men, which exercises both the legislative functions of the city council and the executive and administrative functions of the city mayor, thus abandoning the traditional idea of the separation of legislative and executive powers. The separately elected mayor either disappears as a city official, or becomes a mere figurehead—the representative of the city as a cor-

⁷ Buck, *Reorganization of State Governments*, pp. 33-37.

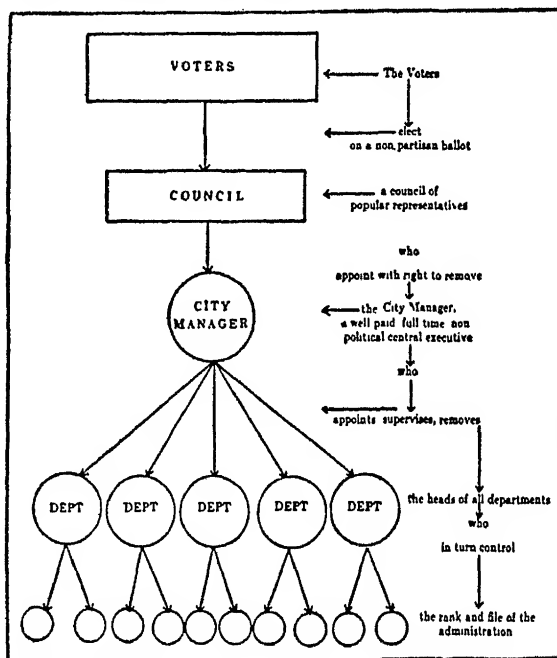
porate entity. Often, a member of the city commission itself is delegated to assume the representative functions of the mayor's office. Occasionally, a city commission acting as a board performs the administrative functions otherwise exercised by the mayor. More frequently they are parceled out among the commissioners, and each thereby becomes more or less of an independent administrative official.

Commission government was first tried in Galveston, Texas, following a severe flood in 1901, as a sort of municipal dictatorship to tide the city over the period of distress. So successful did the experiment prove, that Galveston retained this form of government, and other cities copied it. But the absence of a central executive and administrative authority was a serious weakness, and from 1915 on, the popularity of the pure commission form of city government declined.

Centralization of all administrative functions of city government in a salaried city manager is the essence of the city-manager plan first proposed by the National Municipal League in 1895, and first applied in Staunton, Virginia, in 1908. As of 1941, 517 American cities had "manager" government. A city manager is employed to take over the administrative functions of the mayor in a mayor-council city. Shorn of its executive and administrative importance, the office of mayor shrinks to a mere representative dignity. The office of city manager, however, is usually combined with the council form of city government, and frequently with the commission form. Sometimes the commission itself is divorced of all administrative authority and becomes merely a small legislative chamber. More frequently, the members of the commission remain the executive heads of the various city departments, and are subject to the central administrative control of the city manager.

Under the city-manager plan of government, administrative responsibility can be centralized to the point of utmost practicality, and the injection of politics into administration is minimized. A trained executive, hired for his ability, rather than elected for political considerations, manages the affairs of city government. Relatively permanent tenure, more conducive to efficiency and effective management than the periodic rotations of elected officials, is assured to

the administrative head of the government. By this time, the continued operation of the system in many small and medium-sized cities has given their managers sufficient training to handle competently the affairs of cities of any size.



From Ridley and Nollig, "The City-Manager Profession," University of Chicago Press, 1934

CHART V SHOWING THE RELATION BETWEEN THE VOTERS, COUNCIL, CITY MANAGER, AND ADMINISTRATIVE PERSONNEL

Administrative reorganization of other units of local government must, in most cases, wait upon the consolidation and reshifting of their functions discussed previously. In some of the more populous counties, however, the governments are enterprises of such magnitude that, irrespective of other reforms, they demand the best possible administrative structure. "Manager" government is applicable to counties where wealth and population are concentrated. To date, however, only six of the country's counties have adopted this reform.

Financial organization

Every inquiry into local finances uncovers cases of treasurers or other financial officials of small governmental units who "keep their accounts in their heads," or "put receipts into one pocket and pay

bills out of the other, and keep track of things that way." Such rudimentary financial management may be as effective as any other, if the amounts involved are small and the man is honest and not too stupid. But for any unit spending more than a few thousand dollars a year, such hit-or-miss methods would obviously result in hopelessly tangled finances.

Experience has established the principle that separate units must be responsible for the collection of funds, for the custody of funds, for payments on government account, for budgetary procedure, and for checking governmental payments. These may be set up as separate bureaus within a department, or as separate departments within the general governmental organization. The federal government and most of the state and large city governments have adopted this element of financial management. Tax collection is one of the functions of a "revenue bureau," or a "tax commission," or a "division of taxes and revenue." Funds so collected are received by a "treasurer" who is responsible for their custody, and makes payments from them; usually he is also responsible for the issue of bonds and all debt service payments. A "budget bureau" formulates the budget. And a "comptroller," "auditor," or "accounting office," among other functions, checks expenditure warrants and supervises the accounting procedure of all governmental departments. Counties, towns, small municipalities, and special districts, however, still loosely intermingle the four functions and the offices responsible for them.

Of itself, the creation of separate administrative units for the four functions is but an initial step toward efficient financial management. To the department or division primarily associated with each function must be assigned all the elements of that function. Despite the existence of "tax commissions," tax collection is still uncentralized in many states—gasoline taxes and auto license charges are collected by the highway department, corporation taxes by the secretary of state, bank taxes by the banking commission, and so forth—with consequent unevenness of fiscal administration. One reason for the long-standing abuses in property tax administration in Chicago was the mutually independent status of the Board of Assessors and the Board of Review. When separate or supplementary depart-

ments each maintain bank balances, the city's total operating balance must perforce be larger than if all funds are consolidated and handled jointly through a single "treasurer's" office. Responsibility for all phases of revenue collection, for the handling of all public funds, for the entire budgetary process, and, within limitations, for auditing and accounting control, should in each case be unified and lodged in an appropriate official.

Officials charged with financial functions are too often burdened with supplementary unrelated activities, or, worse still, a major financial function is attached as a supplementary responsibility to some other office. A sparsely settled county may be excused for combining the offices of sheriff and tax-collector, or treasurer and road commissioner, but what justification can be offered for the federal government's assignment of public health functions to the Treasury Department? For some governmental units, budget making is still an *ex officio* function of officials charged primarily with other functions. Sound financial management requires a strict separation of each of the financial functions from other governmental activities.

Most authorities recommend that the financial functions of a state or municipal government be assigned to bureaus unified under a single "Department of Finance," rather than be divided among independent governmental departments. But the official responsible for the final budgetary "post-audit"⁸ should under any circumstances be independent from the other financial offices, and free from executive control. His responsibility is to the legislature. Although some authorities advocate general unification of financial functions, they recommend a separate organization for tax administration so that this function will be given the consideration it deserves. Some administrators and writers also argue for the maintenance of an independent budget agency answerable only to the executive. The current tendency, however, seems to be in the direction of centralizing financial functions. In the past two decades, administrative reorganizations of state and city governments have, with increasing frequency, included the grouping of financial functions under a single Department of Finance.

⁸ See p 157 of this volume.

Should financial officials—tax commissioners, treasurers, comptrollers, auditors, budget directors—be appointed or elected? Critical opinion would seem to be overwhelmingly in favor of appointment for financial officers, with the possible exception of comptrollers and auditors. Voters cannot judge the technical fitness of candidates for such positions. To make these offices the footballs of politics is to throw wide the door to every possible form of corruption and mismanagement. The election of comptrollers and auditors is advocated on the ground that since these officials must check upon the activities of all other administrative divisions, they must be independent of executive pressure. But, with the present state and municipal electoral machinery, the election of such officials usually means their control by a party machine. In the choice between the two evils, most commentators agree that open executive responsibility for comptrollers is preferable to a concealed responsibility to party machines. To preserve the independence of the auditor, or other official who makes the final post-audit of expenditures, his term of office may be longer than that of the appointing executive, or his appointment may be vested in a legislative committee. Two-thirds of the states have provided for an independent audit of local government accounts by making it a state function.

CENTRALIZED PURCHASING

When the hundreds of bureaus and offices of a large government buy their supplies separately, each must purchase at retail. Supervision of multitudes of small-lot purchases is difficult, and the possibilities of petty graft pile up endlessly. Were all supplies purchased through a single agency and then distributed to the individual bureaus and offices according to their needs, not only could the central purchasing agency effect economies by buying at wholesale, but official graft would be more difficult to perpetrate. Central purchasing has been one of the reforms usually associated with administrative reorganization of state and local governments.

The advantages of centralized purchasing may be summarized as follows:

- (1) standardization of materials and supplies makes consumption economies possible;
- (2) purchase by wholesale lots results in lower unit costs and better delivery service;
- (3) discounts can be obtained for prompt payment;
- (4) centralized supervision over deliveries, storage, and distribution of stock, and over interdepartmental transfers and sales, is facilitated;
- (5) overhead governmental costs are cut by reducing the personnel engaged in purchasing activities;
- (6) a full-time purchasing staff leads to improved buying technique and tends to eliminate graft and favoritism,
- (7) accounting control over expenditures can be much closer;
- (8) the volume of "paper work"—checking and accounting—is reduced;
- (9) the vendors' problems are simplified by centering solicitation on a single purchasing office, reducing the number of orders and deliveries, and reducing the number of government accounts.⁹

But careless development of a centralized governmental purchasing agency may result in some disadvantages. Overstandardization may lead to the purchase of qualities unsuited to the needs of the agencies which are intended to use them. The latter agencies may be delayed in obtaining the materials they actually need. To get a bargain price, central purchasing departments are sometimes induced to purchase larger stocks of particular materials than are really necessary. All in all, however, these potential abuses fall far short of offsetting the definite advantages listed above.

Principles of effective centralized purchasing derive not from governmental theory but from business management practices. A central purchasing officer for a city, like the purchasing department of any large business enterprise, has a double task to perform. First, it must organize the purchase requirements of all the various city departments into a coordinated system. Prior to centralization of the purchasing function, each department either set up its own particular specifications and standards, or bought casually what the market readily offered of the items it needed. Often enough there

⁹ See Russell Forbes, *Governmental Purchasing* (Harper & Bros., New York, 1929).

was no sound reason for the variations in specifications established by different administrative departments; these differences in many cases started sometime in the past because of accidental preferences of individual department heads. For effective mass buying, these variations should be eliminated as much as possible, and uniformity in standards and specifications as between departmental requirements be established as far as practicable. An overzealous purchasing officer could overdo the factor of uniformity in purchasing requirements and sacrifice the advantages of the special adaptation of particular supplies to the needs of a particular department. But within the limits of reason, there is a great opportunity for a purchasing officer to educate the other departments of a government to the use of alternative specifications and standards that will permit massing of buying orders with no loss of efficiency and convenience. Often enough, a purchasing officer is able to discover supplies and materials superior to those previously purchased by individual departments. Throughout this procedure of coordinating buying requirements of the various administrative departments, the purchasing officer should act through cooperation and conference, rather than exercise arbitrarily any official authority bestowed upon his office by statute.

The second task is to establish and operate a routine buying procedure. Such procedure for a centralized purchasing department is dictated partly by established business purchasing practice, partly by statute. As in any business organization, the administrative departments must send requisitions for needed supplies through to the purchasing department. The one special governmental feature of these requisitions is that the amounts involved are determined, sometimes specifically, sometimes as to total, by statutory budgetary allowance. Either they must be checked by the comptroller's office to determine whether they are within budgetary authorization, or the purchasing department must itself undertake such pre-audit.

Like any business purchasing department, the purchasing officer of a governmental unit must explore all markets for the items he is buying, maintain sellers' files, collect catalogues, follow price and market trends. He is usually not free, however, like the purchasing

manager of a private business enterprise, to place his orders with the particular sellers who offer the best combinations of terms and special services, to arrange either to concentrate his orders with a single seller to obtain some preferential agreement, or to spread his orders around the market in such a way that the stoppage of any one source of supplies will not jeopardize his general purchasing program. Governmental buying departments are usually limited in their placing of orders by a statutory requirement that their orders must be advertised and placed with the lowest bidder who can meet specified requirements as to delivery bonds, labor conditions, and other details. The purpose of such laws is to eliminate the graft that used to permeate departmental buying, and to prevent departmental buyers from involving themselves in difficulties through their own inefficiency or shortsightedness. With the greater responsibility and higher purchasing efficiency achieved through centralized purchasing departments, many authorities believe that these old restrictions should be relaxed, and that a centralized purchasing official should have the same freedom of action as the purchasing manager of any large corporation.

Centralized governmental purchasing in the United States is essentially a development of the twentieth century. The initial experiment was made by Arizona in 1895, when a Board of Control was empowered to purchase for state penal and charitable institutions. Utah gave a Board of Examiners limited purchasing functions in 1896, Iowa copied the Arizona arrangement in 1897, and Texas provided a purchasing agent for the state eleemosynary institutions in 1899. No other state attempted the reform until 1910. In that year, the Oklahoma State Board of Affairs was authorized to purchase for all the state departments and institutions. Central agencies now purchase either for state departments, or for state institutions, or for both, in all but eight states. Half these states have a board whose members are appointed by the governor or serve *ex officio*. Purchasing activities of the remaining state governments are centralized either in a separate state department or in a bureau of the state finance department.

Centralized purchasing has not yet been installed for the federal

government. An interdepartmental general supply committee established in 1909 prepared schedules of prices for supplies purchased by two or more departments, but did not itself make purchases. A federal purchasing board, organized in 1921 to study the problem of centralized purchasing, recommended intradepartmental centralization of purchasing, and in recent years, some progress has been made along these lines.

Among local governments, the movement for centralized purchasing has made considerable headway. Over two hundred cities and some one hundred counties purchase their supplies through central agencies. In New York City, the central purchasing department established in 1934 was put under the direction of Russell Forbes, the country's outstanding authority on the subject.

Two recent developments that have the hearty support of students of municipal administration are the development of purchasing by a state purchasing department for the smaller local governments of the state, and cooperative central purchasing by municipalities through their state municipal leagues.

PERSONNEL MANAGEMENT

Ultimate determinant of the character and efficiency of government activity is the caliber of the 5,333,000 individuals who perform public services. Able men will accomplish results under any governmental setup. And the most thoroughgoing administrative reorganization is of no avail if the officeholders and employees are knaves and fools. Fully aware of this point, the champions of efficient government have made improvement in the management of personnel part of their program of reform.

A first point of attack is the election of administrative officials. When state treasurers, city commissioners of sanitation, county superintendents of the poor, or township tax assessors are elected by popular vote, the corps of public officials is made up primarily of politicians and vote getters. By the law of probability, some of them will also be good administrators. But their ability in the offices to which they are elected is incidental. Once in office, they must devote their time and attention to maintaining political foot-

holds and preparing for subsequent elections; their official duties are all too likely to be neglected or referred to subordinates. Moreover, they are responsible not to the chief executive, but to the political machine which backed their nomination and election—and which will determine their future careers.

The cure for this evil is the "short ballot" Only policy-determining representatives—the members of the legislative body and the chief executive—should be elected. Administrative officials should be appointed by the chief executive, and be directly and solely responsible to him. Although internal reorganizations of state and city governments during the past two decades have usually embraced this element of reform, scores of thousands of elective offices have still to be made appointive. But the transformation will be difficult. It will be under attack not only from the political machines whose control of state and local government is endangered, but also from an electorate induced to see the reform as an attack on democratic principles.

A distinction must be drawn between policy-determining officials and the subordinate employees who perform the routine of the governmental functions to which political policy applies. The former, as indicated, should be appointed by the chief executive and be responsible to him. It is highly desirable that they understand the functions they are to supervise, but they need not be technical experts in their fields; the efficiency of their departments, in the long run, will depend upon the technical subordinates rather than upon the department heads. According to the executive ability displayed by department heads, their departments may be improved along organizational lines, or be allowed to continue in the grooves established by predecessors and by the routine of the subordinate staff. But, for the most part, the important relation of an appointed department head is with his executive and the electorate that his executive represents, rather than with the department he supervises.

The case is far different with subordinate departmental officials and the rank and file of government employees. Their function is not to develop policy but to accomplish work. Their qualifications should all relate to ability in their positions, and they should con-

tinue in their positions so that they can acquire the efficiency that comes with continued experience. To apply to these subordinate officials and employees the Jacksonian principle, "To the victor belong the spoils," to make appointment to these positions the reward of political affiliation, will produce a government personnel whose major qualification is political facility. Uncertain tenure of office will kill any incentive towards efficient service that might exist.

A "merit system" for the selection and promotion of public employees, and centralization of governmental personnel management, are prime requisites for the efficient conduct of modern govern-

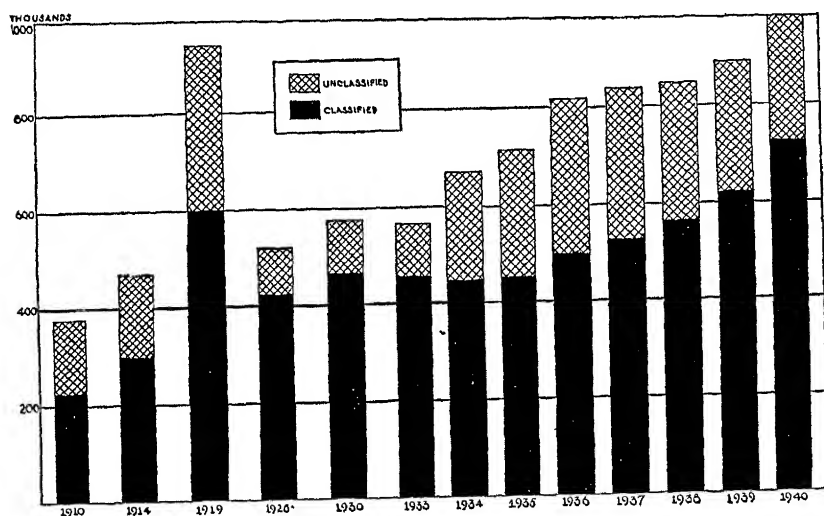


CHART VI FEDERAL EMPLOYEES UNDER CIVIL SERVICE, 1910-1940

mental functions. Proposals for "civil service reform" in the federal field date back to the Whig opponents of President Jackson, but the movement made little headway for a half century. Spurred by the assassination of President Garfield by a disappointed office seeker, Congress passed the Pendleton Act in 1883, which provided for a Civil Service Commission to supervise the selection of certain classes of federal employees. Occasional enlargements of the scope of federal civil service were thereafter made by presidential order. By 1932, however, before the creation of the "recovery" agencies, less than half of the federal employees had "civil service" status. For a

consist of three or more members whose terms overlap, and who are removable only for cause. This has proved the best arrangement in cities where the spoils motive is still strong. City-manager cities find most effective a personnel director immediately responsible to the manager.

But organized "civil service" supervision of government employees is not the only possibility of personnel control. In most states particular groups of local employees are subject to some degree of control by various state departments—education, highways, health, and welfare, for example. The most notable example is the setting of minimum standards for teaching positions or certifying to the eligibility of teachers by state school departments. Similar techniques, including the setting of job specifications, are spreading to other departments. In a growing number of instances, state departments charge themselves with training local employees in their special fields.

The usual functions of a government personnel board or director are: (1) making job analyses, consequently classifying positions according to duties and employee requirements, and recommending corresponding rates of pay; (2) testing qualifications of applicants for employment; (3) establishing standard practices in regard to transfers, promotion, hours, vacations, sick leaves, and the like; (4) preparing, installing, and supervising systems of service ratings for promotion; (5) regulating layoff and re-employment; and (6) passing on cases of discipline and dismissal. No recondite elements of governmental theory are involved in these procedures; they parallel exactly the functions of any progressive business personnel department. An ample literature on the subject exists, not in books on government but in the manuals on business management. So far government personnel practice has lagged behind that of the more progressive business corporations. Civil service examinations given by many states and municipalities, for example, test the applicants' general information, but hardly their qualifications and training for the particular jobs they are to fill. Likewise, wide disparities in pay often exist between similar positions in the different departments of a state or city organization. Employee rating systems are rarely

satisfactory, and all too often promotion is based almost exclusively on seniority, thereby carrying much "dead wood" into the higher administrative ranks and killing all incentive for superior effort and accomplishment.

CUSTODY OF PUBLIC FUNDS

Every government has an officer—a "treasurer"—responsible for the receipt, safekeeping, and payment of its funds. But both the legislator and the fiscal scholar frequently overlook the important problem of what disposition this official shall make of balances on hand. By allowing treasurers considerable discretion in placing public funds pending disbursement, wide avenues may be opened for embezzlement, mismanagement, and graft. Statutory provision must be made for the custody of all government funds from the time of their receipt until their disbursement. Legislative enactment may provide for the deposit of such funds in an independent treasury, in a government bank, or in commercial banks.

Custody of federal funds

While the Treasury Act of 1789 provided that federal funds be kept in a federal treasury, it did not specifically create such an institution. From 1791 to 1811, and from 1816 to 1833, federal funds were deposited in government banks—the First Bank of the United States and the Second Bank of the United States. A series of private banks, the "pet" banks, were entrusted with federal funds between 1811 and 1816, and again from 1833 to 1846. When these banks suspended specie payments during the War of 1812 and again during the depression of 1837–42, the federal government was seriously inconvenienced and suffered some loss.

An "independent treasury" system was established in 1840, re-established in 1846, and lasted, nominally, for seventy-five years. Until the Civil War, federal balances, in currency form, were kept in the treasury vaults in Washington and in subtreasuries established in leading commercial cities. Federal funds were safe from

bank failure, but in periods of recurring federal surpluses their accumulation threatened to deplete the country's supply of circulating currency.

With the establishment of the national banking system in 1863, a new class of government depositories was created. While the national banks were not government banks, they were subject to considerable federal control. In time, federal funds flowed freely between the "independent treasury" and the national banks as occasion and convenience demanded. When the federal reserve banking system was created in 1913, national banks and the federal treasury were expected to be replaced as depositories by the federal reserve banks, though the act specifically provided that commercial banks belonging to the system could be so used. The system of federal subtreasuries was actually abolished in 1921, but the federal treasury's heavy dependence on commercial banks in floating war loans forestalled any complete diversion of federal funds to the reserve banks.

Since World War I, the federal government has maintained only a fraction of its current balance on deposit with federal reserve banks—on June 30, 1940, the amount was \$254,000,000 out of \$1,147,000,000. Instead, over a thousand national and state banks, located at points where they facilitate the transaction of essential government business, have been designated general and limited depositories. There exists also a supplementary system of "special depositories" composed of those banks which have subscribed for federal debt issues, and have credited the purchase price to the government as a deposit subject to withdrawal for current expenditures. On June 30, 1940, there were over 2000 such special depositories; the total of their federal deposits was \$805,000,000.

Custody of state and local funds

State and local current balances aggregate between \$1,250,000,000 and \$2,000,000,000. Their custody is obviously an important item of financial management.

Occasionally, independent treasuries and state-operated banks

have been established as depositories of state funds, but they have never lasted for any long period. No state now maintains an independent treasury, and only Delaware and North Dakota deposit their funds in state-owned banks. All other states place their balances in commercial banks.

Because banks used as state depositories have often failed, and because state treasurers frequently used their power to designate state depositories as a means to get rich commissions from the favored banks, most states have thrown safeguards about the procedure of depositing state funds.¹¹ "Depository boards" commissioned to choose state depositories have generally relieved the state treasurer of his arbitrary power. To insure the safety of deposited funds, some states limit the volume of state funds which may be deposited with any single bank by the amount of the bank's capital and surplus. Furthermore, most states require the bank to give security in the form either of government bonds or a surety bond. That even these safeguards cannot provide complete protection, however, is indicated by the circumstance that at least \$450,000,000 of public funds were impounded in closed banks during 1933.¹²

Interest is generally paid on deposits of state funds, and in a few states the rate is fixed by law. Occasionally, the depository board determines the interest rate. In those states which distribute state funds among depositories on a competitive basis, the interest rate is set by the bidding of the banks.

Until recently, few states bothered to establish statutory regulations for the custody of local funds, but the last decade has seen considerable legislation on this matter. Usually, these laws require that local deposits be made with the bank or banks submitting the best interest bids, and that the depository bank post adequate security. Too frequently, however, local treasurers remain free to arrange for the custody of the funds in their charge, and their office becomes a source of lucrative graft. In many states, the depository banks pay no interest on the funds of local governments.

¹¹ See tabulation in Tax Research Foundation, *Tax Systems* (eighth edition, Commerce Clearing House, Chicago, 1940), pp 297-299

¹² Martin L. Faust, *The Security of Public Deposits* (Public Administration Service No. 51, 1936).

GOVERNMENTAL ACCOUNTING SYSTEMS

Accounting systems for private business enterprise have been compared to instrument boards, reporting in visual coordinated form the financial result of internal operations, so that the owners and creditors of a concern can know how much of an enterprise it is and where, how fast, and how safely it is going. It is equally important for the administrative officials, the legislature, the bondholders, and the taxpayers of a governmental unit to know its financial position and to have a quantitative picture of its operations. By establishing a basis for audits, the accounting system of a governmental unit guards it against the malfeasance and misfeasance of its officials and employees. A technique of governmental or municipal accounting is just as essential to efficient government as business accounting is to sound private enterprise.

Some procedure of recording government transactions has always developed whenever and wherever governments have operated. But a mere tally of receipts and payments hardly constitutes an accounting *system*, and fails utterly to perform most of the functions possible under an effective procedure of accounts. Principles of accounting appropriate to governmental needs have been formulated. The task of today is to develop administrative machinery for the application of this technique, and to persuade legislatures and administrative officials to adopt the improved procedure.

Basic principles

Unlike business accounting, which solves its problems on the basis of experience, reason, and experiment, much of the procedure of governmental accounting is predetermined by constitutional provision and statutory law. Governmental accounting must operate within the framework of laws which create arbitrary "funds," which earmark taxes and other revenues to particular expenditures, which establish specific reporting and budgeting classifications, and which otherwise dictate accounting procedures. Within this framework, sound accounting principles derived from the business field or evolved by reason and testing may be applied. When the law and

sound accounting principles conflict, which they frequently do, the law rules—until it is amended.

The units of governmental accounting are the “funds” established by constitutional provision, by statute, and by executive order. As defined by the National Committee on Municipal Accounting, a fund is “a sum of money or other resources set aside for the purpose of carrying on specific activities or attaining certain objectives in accordance with special regulations, restrictions or limitations.”¹³ Each such fund is an independent accounting entity, with its separate books and statements. Only for reporting purposes is there any combining or aggregating of the accounts of separate funds.

For effective budgetary control and for intergovernmental uniformity in financial reports, the accounting authorities recommend eight classes of “funds”:¹⁴

- | | |
|--------------------------|-----------------------------|
| 1. General fund | 5. Working capital fund |
| 2. Special revenue funds | 6. Special assessment funds |
| 3. Bond funds | 7. Trust and agency funds |
| 4. Sinking funds | 8. Enterprise funds |

Unfortunately, ignorant and indifferent legislation, instead of consolidating and unifying government finances under a minimum number of “funds” falling within the above classification, has spawned “funds” in indiscriminate fashion. The result is at once fiscal confusion and rigidity, hiding the true picture of governmental operations, and blocking efforts toward economy and efficiency. There were in 1940, for example, 175 different federal administrative funds for as many agencies, with accounts maintained on various bases, without any master set of accounts to reflect the total financial operation of the federal government.¹⁵

Proper classification is, of course, an essential of good governmental accounting. As with commercial accounts, there should be

¹³ National Committee on Municipal Accounting, *Municipal Accounting Statements* (the Committee, Chicago, 1936), p. 142

¹⁴ Carl C. Chatters and Irving Tenner, *Municipal and Governmental Accounting* (Prentice-Hall, New York, 1940), p. 33.

¹⁵ Edward F. Bartelt, *Accounting Procedures of the United States Government* (Public Administration Service, Chicago, 1940), p. 49

separation into balance sheet and operating accounts. The latter are subdivided into revenue and expenditure accounts. Revenue accounts should be further classified by sources, to facilitate budgetary estimating and to picture the distribution of tax burdens. Expenditure accounts are set up by departments with subclassifications according to budget-defined objects—personal services, contractual services, materials, supplies, etc.¹⁶ Uniform keying of the various subaccounts within the departmental classifications permits a subsequent functional reporting of expenditures.

Double-entry recording of operations is as essential to governmental accounting as to business accounting. Memorandum tallies offer no protection against omission or error, and provide no instrument for control. It is indicative of the backwardness of governmental accounting that the federal system was not placed upon a double-entry basis until 1907.

Traditionally, government accounts have been reported on a cash basis, revenues and other receipts being noted as collected, expenditures being entered as payments are actually made. While cash accounting provides a record of completed transactions and permits of auditing control at the close of the accounting period, it contributes little to budgetary control. Accrual accounting, on the other hand, pictures obligations incurred but not yet liquidated, and receipts due but not yet realized. Budgetary management is facilitated by accrual accounting, since appropriations can be entered upon authorization, to be subsequently reduced by reversible encumbrance accounts for orders placed, and by voucher records for actual payments. Likewise, the revenues that finance these expenditures appear as receivables on their legal receipt dates. Discrepancies between revenues due and actual receipts can be covered by creation of reserves for delinquent and uncollectible items.

Elements of progress

Improvement of governmental accounting in the United States involves progress along several related avenues.

Prior to the 1920's, the goal of the administrative reformers was

¹⁶ A sample key-number expenditure classification is given in Appendix A, p. 793.

generally to obtain some application of business accounting procedures to the casual confusion of governmental record keeping, even though the procedures of business and governmental accounting are divergent on many points. During the past quarter of a century, a well-integrated art of governmental accounting, adapted to the peculiarities of governmental transactions, has been developed. Monographs on various phases of the subject have appeared.¹⁷ Good textbooks on the topic are now available.¹⁸ But there is still ample opportunity for refining many of the techniques of governmental accounting, and the possibilities of improving their application to particular situations are endless.

As previously indicated, many constitutional provisions and administrative statutes run counter to sound governmental accounting principles. Various departments, commissions, and bureaus have virtual financial autonomy under old administrative laws, and they jealously cherish their prerogatives and oppose being drawn into general accounting systems. Independent funds based on special tax rates, fees, and other revenue items are found embedded in departments or attached to institutions; again there is resistance to the elimination of these special funds and their earmarked revenues, and the carrying of revenue and expenditure into the general fund accounts. Much progress has been made in recent years along this second avenue of reform, but the task ahead, particularly in the field of local governmental accounting, is still tremendous. In some states, a complete overhauling of the state laws establishing the structure of their local governments will be a prerequisite to establishing sound accounting for these local units.

Once the way has been cleared for introducing sound governmental accounting systems, a great labor of education must begin. In small units, some official or clerk must literally be taught the ele-

¹⁷ Particularly valuable are the publications of the National Committee on Municipal Accounting of the Municipal Finance Officers Association—*Municipal Accounting Terminology* (1936), *Municipal Accounting Statements* (1936), *Municipal Funds and Their Balance Sheets* (1938), *Municipal Auditing Procedure* (1939), and *Governmental Cost Accounting* (1940).

¹⁸ Two recent texts in the field are Carl C. Chatters and Irving Tenner, *Municipal and Governmental Accounting* (Prentice-Hall, New York, 1940), and Lloyd Morey, *Introduction to Governmental Accounting* (John Wiley & Sons, New York, 2nd ed., 1936).

ments of governmental bookkeeping to maintain whatever accounting system is installed. Larger units must include in their staffs a trained governmental accountant or even a department of such accountants. Courses on governmental accounting are now offered in many of our colleges, and can even be taken by correspondence, so that a personnel can be readily equipped to handle the new systems of accounts. Where local units are required or invited to install accounting systems prepared by a state agency,¹⁹ provision for instruction in the operation of the system is usual.

A fourth avenue of governmental accounting progress, important for large units, is the administrative location of the accounting function. Experience has shown that this function should be centralized in a single department or bureau. When particular administrative departments are allowed accounting independence, as has prevailed in the federal accounting setup, it is difficult to achieve the overall uniformity of practice necessary for effective budgetary control. The tendency is toward centralization of the function; as of 1938, forty-three states had central accounting departments. Where in the governmental structure the central accounting office should be located is a matter of dispute. In thirty-four states it is attached to the office of the auditor or comptroller, who is frequently an elected official, independent of executive authority; this arrangement has not worked out well. Governments with a centralized department of finance have found it expedient to locate the centralized accounting function with this department. Whatever the arrangement, the central accounting office should be responsible to the executive authority.

Still another avenue of accounting reform is the achieving of intergovernmental uniformity in accounting classifications and practices. Such uniformity allows comparison of costs between comparable units of government, which is often an important factor in drives for economy and efficiency. Uniformity in the accounting systems of local units is accomplished primarily by state statutory prescription. The Municipal Finance Officers Association, the National Municipal League, and other interested organizations have

¹⁹ See p. 159 of this volume.

recently been doing yeoman work in promoting interstate accounting uniformity.

The final avenue of government accounting progress is the development of cost accounting techniques for governmental services. Governmental cost accounting admittedly presents more problems than business cost accounting, because of the difficulty of establishing quantitative units of measurement for many governmental services. Although chapters on this topic appear in the textbooks, only the barest of beginnings has actually been made on the practical aspects of this technique.

CHAPTER VI

Economy and Control in Governmental Expenditure (*Concluded*)

THE GOVERNMENTAL BUDGET

GOVERNMENTAL budgeting, using the term in its broadest sense, is not new in American public finance. Even if vaguely and haphazardly, every governmental body has had to preplan its activities, its personnel, and its material needs. Although the results may be only approximate, each governmental body must reconcile its expenditure plans with its revenue possibilities. However unscientific, this determination of expenditure possibilities by available revenues or of revenue requirements by expenditure programs is in its essence budgetary. But "governmental budgeting" has come to be applied to a definite procedure, rapidly growing more scientific, of pre-determining and controlling governmental expenditures for the sake of balance, efficiency, economy, and careful adjustment to revenue possibilities.

American budgetary reform

At the close of the nineteenth century, the American federal government was the only important national government without a budget system. The departmental requests for appropriations, compiled in a *Book of Estimates* and presented to Congress by the Secretary of the Treasury, neither represented a financial plan nor bound the departments. Later in the session the heads of these departments presented other estimates to Congress. Fourteen committees in the House of Representatives and fifteen committees in the Senate independently reported appropriation proposals in separate bills. And these bills were inflated on the "floor" by the "pork-

barrel" measures of individual Congressmen. Federal revenue bills were prepared by another set of committees

Even more fortuitous was the financial management of the state governments. In some states, expenditures were made on blanket authorizations, often many years old. Rarely did a general review of state expenditure needs or income requirements precede regular enactment of appropriation legislation. State spending agencies presented requests for appropriations throughout the legislative session. In most legislatures, appropriation bills were handled by separate committees, and passed by separate votes.

The states, and not the federal government, took the initiative in budgetary reform. Organizations like the New York Bureau of Municipal Research had a large part in the program of civic propaganda which led to state budgetary reform. In 1910, President Taft appointed a Commission on Economy and Efficiency which reported two years later. Although the Commission's important report on the possibilities of budgetary reform in the federal government was ignored by Congress, it exerted a lasting influence on many state legislatures. California and Wisconsin had enacted budgetary laws in 1911; by 1916, all but two states had passed some sort of budgetary legislation. Subsequent legislation in most states strengthened and improved the procedure. At present the expenditures of all the state governments are controlled by budgetary procedure, though in many cases of a makeshift character. Several states have written budgetary provisions into their constitutions.

Budgetary reform also made considerable progress in the larger cities. Some states¹ imposed uniform budget and accounting requirements upon counties and other local governments by legislative enactment. Eventually, in 1921, the federal government adopted a system of budgetary control for its expenditures.

The budgetary period

Since budgetary authorizations must be approved by legislatures, the budgetary period of any governmental unit is determined by the frequency of its legislative sessions. In the case of Alabama, this is

¹ See pp. 159 and 161 of this volume.

four years. Forty-two of the states have biennial sessions; hence their budgets are for two-year periods. The legislative bodies of the federal government, five states, and most local units meet annually, so they all have one-year budgetary periods.

The beginning date and termination of the budgetary period—one, two, or four years as the case may be—is determined by the fiscal year of the governmental unit. On this subject there is wide diversity in the United States. A few governmental bodies employ the calendar year. Some odd datings are found—October 1 to September 30 in Alabama and Maryland, April 1 to March 31 in Washington. Most state and local governments and the federal government use July 1–June 30 fiscal years.

Two reasons—one obsolete, one currently pertinent—dictate this arrangement. The obsolete reason is that state and local governments used to rely predominantly on property tax revenues which were collected in the fall when farmers had cash from their crops. Thus a government with a fiscal year beginning on January 1 would have to wait nine months for most of its current-year revenue, while one with a July–June fiscal year would obtain funds early in its operating year. The second reason, which applies today and accounts for the recent change-over of Oregon to a July–June fiscal year, is that legislatures commonly convene in January. Thus they have six months' opportunity to debate and adopt budgets, which then go into effect a couple of months after adoption. Such smooth timing is not possible for calendar-year budgets.

Budgetary scope

To be properly effective, a governmental budget should embrace every item of expenditure. Some writers cover this point by the generalization that a budget should be "universal." American governmental budgets rarely, if ever, achieve this ideal in practice. At the time of its installation, the budgetary procedure of the federal government purported to be comprehensive, yet \$79,000,000 of continuing expenditure, unlisted in previous budgets, appeared in the budget for 1929. Until 1932, special fund transactions were not included in the federal budget. Capital expenditures and the expend-

itures of state institutions maintained by special property tax levies are frequently excluded from state government budgets. City governments rarely include capital expenditures, and occasionally exclude the operating expenses of public utilities.

Because of the irregularity of capital expenditures, it has been argued that they cannot be incorporated in regular governmental budgets. Sometimes the proposal is advanced that capital expenditures should be set up in an independent "budget" to be financed expressly by borrowing. Both suggestions are excuses, apologies for the political cowardice that courts public plaudits with expenditures for improvements but would like to avoid presenting the tax bill for such improvements.² In the first place, capital expenditures need not be financed by borrowing. Indeed, later in this volume,³ this common but inconsidered use of public credit is roundly criticized. A substantial part of the capital expenditures of governments should be financed by taxation, so this argument for excluding them from the general budget fails. In the second place, despite the irregularity of individual capital projects, those of a large governmental unit can be so preplanned that the annual capital outlay figure is kept fairly uniform and presents no insuperable budgetary difficulties. The federal government, the largest spender on capital projects, budgets its program of capital expenditure. Several state governments are able to include highway construction outlays in their budgets. A number of cities have prepared long-term programs for capital improvements. A hopeful current development is the promotion of public works inventories, and of local, regional, and state public works planning by state planning boards operating under the leadership of the National Resources Committee.

Special "funds," established by legislative enactment and supported by designated tax "rates," are one of the greatest obstacles to inclusive local budgeting. A county government may operate with a "general fund" and as many as a dozen special and independent "funds"—one for school aid, one for poor relief, one for

² Richard A. Musgrave, "The Nature of Budgetary Balance and the Case for the Capital Budget," *American Economic Review*, Vol. XXIX, June 1939, pp. 260-271

³ See pp. 640 ff. of this volume

libraries, one for road maintenance, and so forth. When functions are so pigeonholed, the budget of the general functions is a distorted document, which presents only a fractional financial picture of past and projected activities.

Special minor revenues earmarked to particular offices or departments also warp the budgetary picture. A sheriff's office, for example, may report only the excess of expenditures over fees received. Or a city department of markets may make no return of license revenues and the expenditures covered by those revenues. Such offices and departments seem to operate on an economical basis, sharing less than pro rata in the general revenue. Yet this apparent economy may mask flagrant squandering of earmarked revenues. For proper budgetary practice, all incidental and special departmental revenues must be included.

While the argument for excluding the expenditures and revenues of institutions supported by special tax levies and of government enterprises from the general state or local budgets is stronger, it is not completely convincing. Such enterprises and institutions frequently incur either deficits or surpluses, which in the long run involve either payments from or payments to the general treasury. The postal deficit, for example, is an item of federal cost which must be taken into account every year. Finances of public enterprises are too closely bound up with the general finances of the governmental units with which they are associated to be excluded altogether from the budgets of these units. Budgets of public utilities and governmental institutions which have earning capacity are best set up as supplementary schedules to the general budget of the governmental body, with the net deficit or net surplus incorporated in the general budget. The federal government has adopted this practice for the Post Office, the Reconstruction Finance Corporation, and the Tennessee Valley Authority.

Essentials of budgetary procedure

Essentials of governmental budgetary procedure have been summarized as follows:

Budgetary procedure involves the bringing together of estimates covering the multifarious needs of a government, the checking of these estimates against recorded expenditure data, the calculation of the government's income in the light of past experience, the preparation of the budget and supporting measures by the responsible executive or other agency of the government, the adoption of the budget and the enactment of the bills designed to carry it into operation by the legislative body, and, finally, the execution of the budget by the executive or the administrative officers in accordance with the authorizations of the legislative body.⁴

On the basis of this summary, governmental budgetary procedure involves three major steps: (1) the formulation of a financial plan, (2) the enactment of legislation to effect this plan, and (3) the execution of this financial plan by executive and administrative officials.

The formulating agency

Governmental budgets in the United States are sometimes formulated by the executive officer, sometimes by a board of administrative officials, or administrative officials and members of the legislative body, sometimes by a committee of the legislative body. "Executive" budgets, the first method of formulation, are rapidly superseding the other types. The federal government has an "executive" budget. Prior to 1939 the federal Budget Bureau was a division of the Treasury Department. In that year it was reorganized and given independent status and responsibility directly to the President. Three-quarters of the states⁵ and a growing number of cities—particularly those having centralized mayor or city-manager government—also have developed "executive" budgets. Budget boards, whose members are usually administrative department heads acting *ex officio*, formulate the budget in a few states; in several cases, the governor appoints special members who have no other administrative duties. In four states, both administrative heads of the gov

⁴ Arthur E. Buck, *Public Budgeting* (Harper & Bros., New York, 1929), pp. 3, 4

⁵ A partial summary of state budgetary organization and procedure is presented in the Tax Research Foundation's *Tax Systems* (eighth edition, 1940), pp. 286-292.

ernment and representatives of the legislature are included in the budget boards. St. Louis, Baltimore, and Milwaukee, among many other cities, have either administrative type or combined administrative-legislative boards to formulate their budgets. Only one state—Arkansas—and a few cities—including Chicago, Los Angeles, and San Francisco—still leave budget formulation to a legislative committee. “Legislative” budgets are quite common among counties and subordinate units of local government.

American writers on public finance and governmental organization agree without exception that the “executive” budget is superior to the “board” and “legislative” budgets. This general approval of the executive budget is based upon the assumption that all authority centers in the president, governor, mayor, or other executive officer, and that he is in the best situation to collect all the information necessary for formulating the budget. For those state governments whose administrative functions have been centralized, and for the cities in which either a mayor or a city manager is truly the head of the administrative machinery, this assumption is valid. But for the state and local governments still laboring under administrative decentralization, the assumption is open to question. Quite possibly, in such governments, a budget board composed ex officio of the administrative department heads is the most effective, if not the only, way to bring together all the necessary information. Governmental reorganization to centralize administration functions is an essential prerequisite to the “executive” budget.

A governor, or mayor, or budget board does not and cannot, of course, either engage in or directly supervise the detailed clerical work of collecting departmental estimates or the more responsible task of studying and revising these estimates. Budget compilation is itself a complete function, worthy of a separate department or bureau. In the absence of administrative centralization of executive functions, a budget bureau responsible to the executive and independent of other governmental affiliations would seem to be the most effective organization for compiling the budget. Such a bureau becomes the instrument by which the executive may effect his budget program. The budget of the federal government is com-

piled by such a bureau, as are the budgets of over a dozen states and of several large cities. If the department of finance is well integrated, one of its bureaus may handle budget formulation. One of the prime requisites of the "executive" budget—the sole and undivided responsibility of the executive—is lost, however, unless the department is completely subservient to the executive. A third possibility arises when the budget is formulated by a board. The labor of compilation may be performed, as in Michigan, by a permanent budget staff attached to the board.

Formulation procedure

Budget formulation for a large city or state government, or for the federal government, usually begins nine to twelve months in advance of the fiscal year to which it will apply. Department heads must work out their estimates, the formulating agency must collate, adjust, and incorporate the estimates into a unified budgetary proposal, and the legislative body must pass upon the proposal. For governmental units whose fiscal year runs from July 1 to June 30, formulation procedure usually begins in the late summer of the preceding year, and lasts until the budget is adopted in the following spring. Federal budget preparation, for example, starts a whole year in advance of the beginning of the fiscal year to which the budget applies; spending departments and agencies have to submit their estimates to the Budget Bureau in mid-September. In states with biennial legislative sessions, departmental estimates for a two-year budget or for two one-year budgets have to be submitted nine months in advance of the first budgetary year.

The first step is usually taken by the budget bureau, or equivalent agency, which calls upon all department heads for their estimates on the forthcoming budgetary period. To facilitate the making of these estimates, the budget agency usually sends each department head a standard form which lists the actual expenditures of the department for the preceding fiscal year, or sometimes for two or three years.⁶ These previous expenditure tabulations are not intended to provide a hard and fast precedent, but, except where special depart-

⁶ Sample budget forms are given in Appendix A, pp 794 ff.

mental developments are occurring, a considerable year-to-year consistency is expected and enforced by budget bureaus. In consultation with their chief subordinates, the department heads estimate forthcoming expenditures and incidental receipts according to a pre-arranged uniform accounting classification,⁷ and enter the figures under the appropriate keyed headings. Entries are made in detail, only identical material items or position grades being grouped.

Revenue collecting departments must also present their estimates of receipts during the budgetary period. Such anticipations of future revenues are bound to be plagued by uncertainty. Some taxes are relatively stable in their yields,⁸ and past collections ordinarily offer a fair guide to estimates on future receipts. For example, unless a major economic boom or collapse occurs, property tax assessments remain fairly stable or, in growing communities, expand in consistent proportion, so that local governmental units can usually estimate this item of revenue to a surprisingly close figure. But the inflationary increase of values from 1916 to 1920 threw all property tax estimates during those years off base, as did the decline of property values and the increase of tax delinquencies from 1930 to 1934. Federal and state budgetary estimates of personal income and business tax receipts, which involve business forecast analysis, are frequently wide of the mark. And estate and inheritance tax yields, which can be influenced tremendously by the chance grouping of the deaths of rich individuals, cannot be prognosticated except as to their normal minimum.

Departmental expenditure estimates, together with the tax commission's or assessor's estimate of probable revenues, are returned to the budget bureau. There they are consolidated into a single document. Almost invariably, the expenditure estimates exceed the revenue estimates, and the process of "balancing the budget" ensues. In a small municipality, the mayor calls in his department heads and presents them the problem of paring their estimates. In a larger governmental unit, examiners comb through the original estimates to pick out possible savings, presumably solely with an

⁷ See p. 793 of this volume.

⁸ The general subject of revenue stability is discussed more fully on p. 302 of this volume.

eye to efficiency and economy, often in practice reflecting extraneous convictions and prejudices of the individual examiners. Then come conferences between the budget director and the department heads, protests that the original estimates were irreducible minima, bickerings, recalculations. At last proposed expenditures and anticipated revenues balance. Should they fail to balance, the legislature must find new revenues—or dodge the issue for the time being and allow a deficit to accumulate.

Granting all the sound labor which goes into budget formulation, and in the long run produces more honest and more efficient government, the many pious, and not a few impious, frauds perpetrated in the process must not be overlooked. One acute student of local government writes:

Anyone who is acquainted with the sinuosities of municipal politics will tell you that the [budgetary] process is often accompanied by a good deal of shadow-boxing to impress the public. For example, when the estimate-sheets are sent out to the various departments, the mayor sometimes passes out a tip that he wants the opportunity to make some drastic cuts when the proper time arrives. The heads of departments take the hint and pad their estimates accordingly. The totals then prove to be sky-high, whereupon the mayor calls in the newspaper reporters and with a great show of indignation assures them that he is not going to stand for any such extravagance as these heads of departments propose. On the contrary he is going to insist on drastic reductions all along the line, thus performing his full duty to the taxpayers. So the newspapers proclaim in flaming headlines: "Mayor Proposes to Cut a Million Dollars from the Budget," and half the people believe it.

But it is all a publicity gesture and involves no saving at all. The mayor merely takes out of the estimates what should never have been put in. And after he has finished doing this it usually turns out that the totals are still considerably in excess of what was appropriated for the preceding year. The tax rate goes up, and when people complain about it the mayor assures them that nothing but his stern economizing prevented the taxes from being raised a good deal more. This sort of thing has been worked off

on the taxpayers of some American cities year after year. It is a marvel that they do not get tired of it.⁹

The Roosevelt administration played a trick or two with federal budgetary practice in the 1934 fiscal year. Rather than admit that its recovery and relief program would drastically "unbalance" the federal budget, it divided the schedule of federal expenditure into two categories, "ordinary" and "emergency." The ordinary budget would be balanced by current revenues; the "emergency" budget, presumably temporary, would be covered by borrowing. But—many public works which had long been a regular part of the federal expenditure program were quietly shifted into the "emergency" budget. More than counterbalancing this, however, in 1936 the Tennessee Valley Authority's expenditures, the farm relief program, and other projects originally undertaken as a recovery and relief element, were shifted from the "emergency" to the "ordinary" budget.

Form of the budget document

Budget documents are prepared for submission to legislative bodies in almost as many forms as there are governmental units operating under budget systems. Trial and error, however, are slowly establishing certain pragmatic rules.

Governmental budgets should be prepared in three sections. Summaries of past and proposed expenditures, set up in functional form, should appear in the first section. The summaries contained in the federal budget reports since the 1934-1935 issue have been of greatest value to Congress and to the general public; they provide an indispensable bird's-eye view of past and proposed federal finances. Good budget summaries are also published for some half-dozen states. State and local budget summaries occupy a very few pages, and might well be printed separately from the body of the supporting schedules and be given wide public circulation.

⁹ William B. Munro, *Municipal Administration* (The Macmillan Co., New York, 1934), p. 161.

A second part of the budget document should contain the detailed schedules of the proposed and actual expenditures of the preceding year or biennium. These are the vital body of the budget. Since the legislature must pass upon these items in formulating its final appropriation bill, it is essential that the statement of proposed expenditures be explicit and detailed.

The third and last part of the budget should indicate the proposed methods of raising the funds to cover the budget expenditures. As with expenditure schedules, revenue operations of the preceding year or biennium should be placed beside the proposals for the coming budget period.

In the federal and in state budgets, for the formulation of which expert accountants are available, minuteness of detail and classification is possible and even desirable. The legislature must be able to view the budget both as the proposed expenditures for various governmental functions and as the proposed disbursements of a set of governmental departments. Governmental departments are not always organized on strictly functional lines, and a complicated cross classification may be necessary to show the budget figures in both relations. Current and capital expenditures should also be distinguishable in budget figures.

Where uniform budgets are required of local governments, it is essential that they be simple in form. In many cases, the local officials called upon to formulate such budgets have no accounting experience or knowledge.

Enactment of a budget

Once a budget proposal has been compiled, it is transmitted to the legislative body of the government. There it may be referred either to a standing committee on finances or appropriations, or to the legislative body sitting as a committee of the whole. In any case, the committee can call administrative officers, demand accounts, and take all other steps to aid it in its determination of the various elements of the budget. Unless the legislature is barred from increasing the budget, much of the work of the formulating bureau may be undone in committee, particularly if influential de-

partment heads have an opportunity to plead against cuts that have been made by the budget bureau. On the basis of its considerations, the committee prepares and introduces an appropriation bill. The following picture of Congressional budgetary procedure, with allowance made for the smaller size of the legislative chambers, could be duplicated in its broad outlines in most state legislatures:

The President's budget, upon being submitted to the House, is referred immediately by the speaker to the Committee on Appropriations. If it happens to contain any revenue proposals, they are referred to the Committee on Ways and Means. The chairman of the Committee on Appropriations at once parcels out the expenditure proposals of the budget to the subcommittees, . . . each of which is responsible for drafting a major appropriation bill along the general lines determined by the whole committee. The subcommittees start work on the departmental estimates assigned to them by holding "hearings" at which the departmental officers are required to give testimony regarding their expenditure needs as set forth in the estimates . . . Sometimes these hearings are started as much as a month before the budget is submitted to Congress, indeed, it often happens that some of the appropriation bills are almost ready for consideration by the House when the budget is received. This procedure is possible because the departmental estimates are transmitted to the Committee as soon as they are scrutinized and revised by the Bureau of the Budget, which may be from three to six weeks before the budget is completed. . . . As the appropriation bills are reported out by the Committee and passed by the House, they are sent to the Senate. Here they are referred to the Committee on Appropriations, and again parceled out by the chairman to subcommittees. When these bills have been examined and revised by the subcommittees, they are reviewed by the whole committee and reported to the Senate for action. The revenue measures are handled in a similar manner by the House Committee on Ways and Means and by the Senate Committee on Finance, each working as a unit.

Appropriation bills are usually handled in a routine manner and passed without satisfactory debate. As these bills come from the House Committee on Appropriations, they are first considered in committee of the whole. . . . Each bill is steered through the House by a member of the Committee on Appropriations, usually

the chairman of the subcommittee directly in charge of the bill. When the motion is made to go into committee of the whole on an appropriation bill, an agreement is reached on the length of the so-called general debate on the bill, a matter which is in the hands of the chairman and the ranking member of the "opposition" on the subcommittee which drafted the bill. This debate usually lasts for two or three hours and unfortunately does not have to relate to the appropriation bill under consideration, totally irrelevant matters may be, and generally are, discussed by the participating members. After general debate is concluded, the bill is taken up section by section for discussion and amendment under what is known as the "five-minute rule." At this point, all discussion must be germane to the section of the bill under consideration. . . . During this debate, which is often little more than a grand gesture, the House is supposed to scrutinize the recommendations of the Committee on Appropriations and make known its wishes with respect to them. In reality, it usually supports these recommendations, amendments rarely being⁹ made when opposed by the committee spokesman. Following the consideration in committee of the whole, the bill is reported back to the House with any amendments that may have been adopted. These amendments are then voted on by the House; the bill is given its third reading at which no amendments are permissible, is passed, and is sent to the Senate.

In the Senate, the procedure for consideration is essentially the same, except that senators may not propose amendments to an appropriation bill from the floor, as representatives may under committee of the whole. No senator can offer an amendment to an appropriation bill the effect of which is to increase the amounts already contained in the bill, or to add new items, unless it is to carry out existing provisions of the law. The desirability of amendments of any other character must be passed upon by the appropriate committees on general legislation.¹⁰

Final determination of the budget and of the appropriation bills which enact it are legislative matters, and must, therefore, be within the discretion of the legislature and its committees. But the great purposes of the budget are lost if interested individuals in the legislature or its committees can modify the budget and appropriation

¹⁰ A. E. Buck, *The Budget in Governments of Today* (The Macmillan Co., New York, 1934), pp. 201-2, 208.

bills to suit their pleasure, or introduce separate appropriation and revenue bills at will. In practice, the executive's proposals frequently carry no more weight than the political circumstances of the moment happen to lend them. Legislatures, it has been argued, should be allowed to reduce but not increase budget items. To strengthen their position as critic of executive proposals for appropriations, they should abdicate their function of initiating appropriation legislation. These principles have been incorporated in the budget laws or constitutions of several states, and are included in a number of city charters.

Such provision gives the executive an element of legislative power, in that he can determine the maximum extent of a government's activities for the budgetary period. For this reason, attempts to limit legislative action on budgets and appropriation bills have been strenuously opposed. Legislative power to determine and modify the budget and appropriation bills has tended to remain untrammelled, but limitations have been placed on the character and form of special appropriation bills. Some state legislatures may not consider such bills until both houses have passed upon the governor's budget bill. Special appropriation bills may be required to embody specific provision for raising the revenue necessary to cover the proposed expenditure. In the case of the federal government, Congress has evidenced an unfortunate propensity to authorize special appropriations in excess of those asked by the President in his budget. Both the President and the Treasury Department must be held partly responsible for this attitude on the part of Congress. During the 1920's, Treasury estimates of anticipated revenues fell considerably short of actual collections and Congress inferred that even were its appropriations in excess of budgetary requests, sufficient revenue would always be available.

Some state legislatures and many local legislative bodies have sought a short cut through the weary detail of budgetary authorization by voting "permanent" or "continuing" appropriations for specified departments or functions. These "permanent" appropriations are set up in a special budget, or special section of the general budget, to which little further consideration is given. Unless an

increase in such an appropriation is desired, it goes through year after year unchanged. Such practice is all right where the items involved are truly stable, such as interest payments on a nonserial debt or salaries established by constitutional provision. There is also considerable justification where "permanent" appropriations constitute minima for important institutions whose functions might be jeopardized by arbitrary budgetary cuts or by a budgetary hiatus resulting from a legislative deadlock. But "permanent" appropriations must be sharply condemned as a negation of sound budgetary principle in all other cases. On the one hand, such appropriations often "freeze" departments that should continue to develop but cannot because the legislature declines to reopen an appropriation line. On the other hand, a declining function covered by a continuing appropriation invites squandering of funds made available where they are not needed.

When legislatures enact appropriation bills, they may authorize budgetary expenditures either by specific appropriations for the detailed items of each department's activity, or by large lump sums for each department. Detailed appropriations are likely to strait-jacket departmental activity, particularly when the budgetary period is quadrennial, as in Alabama, or biennial, as in forty-two other states. From another angle, detailed appropriations become mandatory appropriations which the executive cannot reduce, even when reduction is desirable. So vital did this point become during the depression years, that several state legislatures authorized the governor to reduce the detailed appropriations they had voted. Lumped appropriations, on the other hand, may constitute blank checks which virtually place the administrative branches of the government above legislative control. Alexander Hamilton, who fought for lumped appropriations at the outset of the federal government's career, was overruled by Congress. Under the stress of recovery and relief financing, the Roosevelt administration won the boon of lumped appropriations, thereby investing itself with policy-determining powers wielded by no predecessor.

No one standard can be fixed to determine the extent to which budgetary appropriations should be detailed or lumped. A num-

ber of considerations must influence the legislature's decision. The longer a budgetary period, the less detail should be inserted in the appropriations. Appropriations can be more specific if the legislature authorizes budgetary expenditures shortly before they are to be made than if the bill is passed far in advance of the time of spending. If the executive exercises strict supervision over the execution of the budget, the legislature may be justified in making lumped appropriations for each administrative department. Current expenditures such as the salaries of departmental personnel, which continue more or less unchanged from year to year, can safely be lumped. Appropriations for special projects may with more justification be detailed.

American legislatures have given little thought to the problem of lumping or detailing appropriations. Because of their fear of giving the executive and the administrative officials too great power in the disposal of public moneys, their appropriation acts have tended to be too detailed. Congress, which until recently opposed executive budgetary control, favored detailed appropriations—and then freely voted deficiency bills.

Supplementary budgetary authorization

At its best, the formulation of a budget involves much blind guesswork. Guesses are superimposed on guesses when the legislature, in the course of authorization, changes the recommendations of the budget bureau. When the time for actual expenditure comes around—nine to twenty-one months later for governments with one-year budgetary periods, twenty-one to thirty-three months later for units with two-year periods—circumstances may have so altered that the original appropriation is woefully insufficient or extravagantly excessive.

Budgetary practice takes account of appropriation deficiencies in three ways. The simplest and most troublesome is to introduce a special "deficiency appropriation" bill if the legislature is in session at the time, or to call a special session during an intersession period if the emergency is sufficiently critical. The practice is generally frowned upon, both because of the expense and trouble of special

sessions, and because the voting of deficiency bills at regular sessions opens wide the door to departmental flouting of the regular budget and to "pork-barrel" legislation. But there is no alternative when a government is faced with a tremendous emergency which could not have been foreseen—such as the development of the federal defense program after May 1940, or the progress of the relief crisis in the states during the early 1930's.

The second method of handling inescapable deficiencies is the inclusion in the regular budget of a special supplementary or contingent fund administered by the executive, or the comptroller, or some board.¹¹ Departmental deficiencies, if approved, are covered from the supplementary fund.

The third and most common technique is an arrangement for transfer of funds between departments. In normal times, the deficiencies encountered by some departments of a governmental unit are likely to be fairly closely balanced by excesses developed by others. Transfers solve both problems simultaneously. Approval of the executive, or the comptroller, or some other high official or board is generally required for such transfers.

Excesses, like deficiencies, must be expected, and some regular procedure must be established for their disposal. The most common arrangement is that any excess of appropriations over actual expenditures at the end of a budgetary period simply lapses. Sometimes such excesses are transferred to a special debt retirement fund. Quite frequently, they tend to be absorbed by transfers to cover other departmental deficiencies.

A number of states, particularly in the south, make budgetary appropriations conditional upon availability of revenue. Should available funds be insufficient to cover original appropriations, the governor or budget bureau is authorized to reduce certain classes of appropriations. In Alabama the governor must reduce all appropriations pro rata. A sliding scale arrangement of applying graded cuts to different classes of appropriations has been worked out for

¹¹In Ohio, for example, the board administering the supplementary budget fund consists of the director of finance, the attorney general, and the chairmen of the Senate and House finance committees.

West Virginia. In some other states—Idaho, for example—the governor or budget director has power to reduce particular appropriations that may seem excessive.

Execution of a budget

If, after a budget had been voted, the departments ignored the schedules drawn up for them and spent solely at their own discretion, all the labor of budget formulation, all the legislative scrutiny of appropriation proposals, would count for naught. Departmental expenditures must be under continuous check by the executive. Both he and the administrative officials must be held accountable to the legislature. The instruments for effecting this control are the pre-audit, the allotment, and the post-audit.

Most governmental expenditures are made by checks drawn by the treasurer of the unit upon authorization or "warrants" prepared by the departments. Sound procedure requires that an intervening official, usually called a "comptroller" or "controller," scrutinize all warrants to determine their legal propriety and legislative authorization. For the federal government, pre-audit as well as post-audit work is done by the General Accounting Office under the Comptroller-General. Less than half of the states, and some of the larger cities have established comptrollers' offices for pre-audit work. In many of the other states and municipalities, however, some pre-auditing is done by the auditor's office or by the department of finance. Government auditing differs from business auditing in that it looks primarily to statutory authority for expenditure items rather than to the honesty and expediency of the payments. In the course of time, many legislatures have so hedged departmental expenditure with restrictions that pitfalls lurk on every side.¹² A pre-

¹² Among the legislative provisions limiting federal expenditure procedure are the following: purchases and contracts for supplies or services must be made after advertising and allowing sufficient time for the submission of bids, unless immediate delivery or performance is required by the public exigency, American materials and manufactured goods must be purchased for public use, unless the head of a department or establishment finds it inconsistent with the public interest, or the cost unreasonable, no advance of public money shall be made in any case whatever, it is obligatory upon governmental departments to purchase articles manufactured by the federal prison industries when they are available, before making similar purchases elsewhere, all printing, except such classes of work as shall be excepted by the Joint Committee on Printing, must be done at the Government Printing Office; law

audit of departmental expenditures before payments are actually made is a valuable safeguard to departmental officials who otherwise might innocently find themselves making improper payments. Several state pre-audit officials, however, have interpreted their function as giving them a blanket right to check upon the expediency of details of departmental expenditure. Such policy must be sharply condemned as a perversion of the purposes of the pre-audit, and more likely to impair departmental efficiency than to accomplish sound economy.

While checking upon the statutory authorization for expenditures, the pre-audit official can maintain a running account of each department's payments and determine whether it is keeping within its budgetary allowance. The federal General Accounting Office headed by the Comptroller-General maintains, among other functions, an auditing control over Treasury receipts and disbursements. But the Comptroller-General's independence of executive control has led to conflicts of authority, and the issue has become confused. Through a "pre-audit" reported in summarized form, the executive can maintain current supervision over all department expenditures.

Some state and a few city governments divide the budgetary appropriations to the administrative departments into quarterly or monthly "allotments." Before a department can obtain its allotment

books, reference books, and periodicals cannot be purchased from generally or specifically appropriated funds unless purchase is expressly authorized by law; purchase of newspapers and periodicals from contingent funds when such newspapers and periodicals are not "necessary to the business of the office" is limited to \$100 annually in the case of department heads and \$30 annually in the case of other executive officers; no employee of the Pinkerton Detective Agency, or similar agency, shall be employed in any government service, no appropriated money may be used for compensation of any publicity expert unless specifically appropriated for that purpose, nor shall any appropriated funds be used to compensate or pay the expenses of accountants or other experts in inaugurating new or changing old methods of transacting the business of the United States, no land may be purchased by a governmental department or agency unless under a law authorizing such purchase, no site may be purchased for the purpose of erecting a public building until the written opinion of the Attorney-General shall be had in favor of the validity of the title, nor until consent of the state legislature has been given, expenditures on a public building may not be made until plans and estimates have been submitted to the supervisory architect of the Treasury Department and approved by the Secretary of the Treasury, furniture for all new public buildings must be procured in accordance with plans and specifications approved by the supervisory architect of the Treasury Department, leases may not be let for other than cash rentals.—John McDiarmid, *Government Corporations and Federal Funds* (University of Chicago Press, Chicago, 1938), pp 9-10.

for the period, it must submit to the budget bureau a quarterly or monthly estimate of anticipated expenditures under its appropriation. While the departments are not rigidly bound to these plans, the executive head must authorize any serious departures from them. In this way, not only are the departments kept within their appropriation limits, but the executive can so harmonize expenditures as to minimize temporary borrowings in anticipation of tax revenues. Administrative departments in the federal government obtain quarterly allotments of funds; for any excess over their allotments they must file "waivers." But while the Budget Bureau can warn or scold departments for failing to keep within quarterly allotments, it cannot actually control their expenditures.

When a budgetary period is completed, the legislature should receive assurance that the administrative agencies have made their expenditures in accordance with the appropriation bill or bills. Such assurance should take the form of a "post-audit" made by a qualified agency independent of the executive, and reported to an appropriate legislative committee.

In many states, the State Auditor's or State Comptroller's office makes the post-audits for the small local units. Where this procedure has not been authorized, the county board or city council may employ private accountants for the task. The federal government, state governments, and large local units assign the function to a special official—a comptroller or auditor. Unfortunately, since he is often charged with pre-audit and other accounting functions as well, his responsibilities to the executive and to the legislature are confused; ugly controversy over the federal Comptroller-General's office has arisen from this overlapping allegiance.

Conclusion

So broad and so obvious are the advantages of governmental budgeting that government operation without a budgetary system is cause for amazement. Systematic budgeting substitutes planning for chance in the operation of government departments and agencies, and is thus of immediate benefit to administrative officials. Through foreplanning the work to be done and integrating ac-

tivities and needs, each department and bureau can be assured a reasonable quota of the total fund available for governmental expenditure. When requests for appropriations are presented in an organized form, the legislature is at once permitted and compelled to think of the various government activities as parts of a whole. "Pork-barrel legislation" and "logrolling," two of the chief abuses of former legislative appropriation procedure, can be eliminated by limiting the legislature's power to modify requests for appropriations. Legislators are then compelled to deal with appropriation bills as economic and administrative measures, rather than political footballs. Finally, the budget assists taxpayers to comprehend and control the activities of their governments. A study of the budget shows them how much money is being raised for the support of the government and the purposes for which every dollar is to be expended. Properly prepared and thoroughly discussed before the legislative body, the budget is a most valuable source of public information.

CENTRAL SUPERVISION AND CONTROL OF LOCAL FINANCES

Thousands of interested observers constantly watch the fiscal operations of the federal government, of the state governments, and of the governments of the larger cities. While inefficiency and graft in these governmental units are far from unknown, there is a strong probability that sooner or later they will be uncovered and exposed to a pitiless publicity. County, town, and small village governments, however, often function in relative obscurity. Graft and waste color their operations without ever coming to public attention. For any individual local government the loss through graft or waste may be small, but it may aggregate millions of dollars for all local governments in a particular state.

It is too much to hope that a progressive political leader will step forward in each local governmental unit throughout the country to place its finances on a sound business basis, and provide some means for keeping them on that basis. In the case of the minor

local governments, if fiscal reform is to have any general application, it must be imposed from above.

Constitutional or statutory limitations on borrowing and tax rates are a rudimentary and often an ineffective attempt to prevent local extravagance.¹³ Many states have gone further and prescribed uniform local accounting and budgetary systems. A considerable number provide for state supervision of local accounts. A few have even provided for the actual supervision or control of local government finances by agencies of the state or other central government.

State prescription of local accounting systems

In 1878 the Minnesota legislature authorized the preparation and installation of a uniform system of accounts for all counties in the state—an authority which was never exercised. By 1939, compulsory uniform accounting systems for one or more classes of local units were authorized in twenty-one states, and optional systems prepared by state agencies were available in another fifteen.¹⁴

“Uniform accounting” is a fairly elastic concept with reference to the varying problems of municipalities, but can be accomplished with fair success in counties, whose administration is more standardized. Early attempts to force well-meant but arbitrary record systems on all governmental units of a given class frequently failed of fullest success, sometimes because of defects in the proposed system, more usually because of open or passive opposition on the part of the local officials. Supervisory agencies now emphasize education of local officials and cooperation with them as vital elements in the approach to accounting uniformity.

A National Tax Association committee on municipal accounting which has been working recently on the problems of uniform local accounts, has presented the following preliminary recommendations:

1. The accounts should be centralized under the direction of one officer, who should be responsible for keeping or supervising

¹³ Limitations on local borrowing and indebtedness are considered on pp. 631 ff of this volume. Limitations on local tax rates are considered on pp 397 ff of this volume.

¹⁴ A tabulation of provisions for uniform local accounting systems is presented in Tax Research Foundation, *Tax Systems* (eighth edition, 1940), pp. 293-294.

all accounts and for preparing and issuing all financial reports. . . .

2. The general accounting system should be on a double-entry basis with a general ledger in which all financial transactions are recorded in detail or in summary . . .

3. The accounts should be classified in balance fund groups. . . .

4. A common terminology and classification should be used constantly throughout the budget, the accounts, and the financial reports. . . .

5. The general accounting system should include budgetary control accounts for both revenues and expenditures.

6. The use of the accrual basis in the accounting for revenue and expenditures is recommended as far as practicable

7. The accounting for municipal-business enterprises and institutions should follow the standard classifications employed generally by such enterprises.

8. There should be general uniformity in the financial reports of all municipalities of similar size and type.

9. A periodic audit by independent accountants is recommended.¹⁵

Experience in the states which have prescribed local accounting systems indicates that a *simple* basic procedure is the most important of all requirements. Small units would derive no benefit from many of the accounting refinements necessary for larger, more complicated governments; their officials would properly resent the added responsibility and labor. Using a simple basic procedure, successively more refined accounting systems for superior classes of governmental units can be built up with no sacrifice of comparable uniformity. Moreover, all that should be prescribed is a minimum; any unit should be free and encouraged to adopt refinements upon the prescribed minimum and so improve its system. State assistance is usually essential to the successful installation of prescribed local accounting systems.

¹⁵ Lloyd Morey, "Possibilities and Problems of Uniform Municipal Accounting," *Proceedings of the Twenty-Ninth National Tax Association Conference*, 1936, p. 386. A recent report entitled "Standards for Municipal Accounting and Finance," published by the Municipal Finance Officers Association of the United States and Canada, makes more or less the same recommendations.

State inspection of local accounts

Local auditors or accountants cannot always be trusted to check the accounts of local officeholders. Collusion between the two to cover misappropriations of public funds is too frequent to be dismissed as unusual. Realization of this danger has led the states to provide for state auditing and supervision of local accounts. A Minnesota law directed state inspection of county accounts and vouchers as early as 1878. By 1900, six other states had made such provision; the Wyoming constitution of 1890 created the office of State Examiner of Local Accounts and charged it with the inspection of all local government accounts. After 1900 the practice spread rapidly. At present, only two states—Georgia and Illinois—fail to provide some form of state inspection of local accounts.

The most elementary but most effective element in state inspection of local accounts is the periodic or occasional examination of local accounts by state auditors. In nearly half the states, both county and municipal accounts are subject to state examination; other states limit such examination to the accounts of specified classes of local governments.

Greatly facilitating state inspection is the requirement that local governments make periodic report of their financial status to some state agency. Over half of the states require both counties and municipal governments to make such reports; a few limit the requirement to one class of government. Full financial reports are required in most instances, some states, however, require a reporting of local debt status only.

State prescription of local budget systems

Still another check upon local financial procedures is the statutory prescription of local budgeting procedure and forms. Washington, Indiana, Florida, and Nevada took this forward step before 1920; seven more states followed suit during the 1920's. To guide legislative action in this field, the National Municipal League in 1928 published a Model Municipal Budget Law. At present, two-thirds of the states require local preparation of budgets, and half of the states

require such preparation to be in accord with state-established procedure.

The purpose of this legislation is to erect a first line of defense against local deficits, and to avoid local extravagance by correlating anticipated revenue and expenditure. Under these local budget laws, local units may not set tax rates or pass other revenue measures until they have prepared an estimate of expenditures. Statutory rules prescribe the estimating of revenues and expenditure by regulating procedures to be adopted respecting surpluses or deficits, tax yields, tax delinquencies, offsets for uncollectible revenue, reserve accounts, illegal expenditure, emergency appropriations, and other fundamental elements of budgetary technique.¹⁶ A common provision is that local budgets must be formulated and adopted before the fiscal year begins so that there will be no budgetary hiatus. Another is that a prior year deficit must be included as an expense item in the current year budget. Tax delinquency notes must be paid off during a one-to three-year period in order to forestall accumulation of floating debt. Some provision is generally made for a simple pre-audit procedure or other administrative check on the execution of the local budgets.

Prescribed local budget systems, like prescribed local accounting systems, must start with a supremely simple basic formula for the smallest units of government. Refinements and variations to meet the special conditions in larger or more complicated units are built up from this foundation. The statutory budgetary requirement for each governmental grade constitutes a minimum for the units to which it applies; any unit interested in developing a more refined procedure is free to do so.

Mere passage of a local budget law will not accomplish much of a reform. Local units generally require considerable state assistance in adjusting themselves to smooth working of the prescribed system. Some state agency should prepare standard forms to conform with the statute, and these forms should be either recommended to or made mandatory upon the local units. Experience has indicated,

¹⁶ Wylie Kilpatrick, *State Supervision of Local Budgeting* (National Municipal League, New York, 1939), p. 39.

also, that periodic check by a state agency of the local budgetary procedures is helpful, possibly even necessary, in effecting the purposes of the law. An extreme example of such state checking of local budgetary procedure is offered by the New Jersey law of 1938 which created a State Department of Local Government headed by a commissioner. Among other duties, this commissioner must examine all local budgets, not to judge the wisdom of their expenditure or revenue provisions, but to ensure that they conform with the rules established by the Local Government Board, another state agency established by the 1938 law. A local government can appeal the commissioner's decision to the Local Government Board and to the courts, but meanwhile the revised version of the budget established by the commissioner goes into effect.

State control of local finances

Several important local functions have long been subject to a considerable degree of state supervision and even control. Public education is the leading example. All states require that regular and often comprehensive reports be made to state departments of education, and about two-thirds of the states maintain staffs of educational inspectors. In the highway field, state highway commissions, state departments of public works, or state engineering departments exercise a varying degree of supervision over local road construction and maintenance; in a few instances, the state department has the power to select and remove local highway officials. Thirty states subject local charitable institutions to inspection. In the administration of public health work, the states have assumed a very large measure of control. In fact, as far as public health work is concerned, the counties and municipalities in some states are little more than administrative districts for a semi-state function. And finally, as will be discussed later,¹⁷ state supervision is an important factor in effective local tax administration.

During the past two decades, a number of states have embarked upon a much broader program of controlling local expenditures. Indiana took the initiative in 1919 when the legislature vested the

¹⁷ See p 374 of this volume.

erty tax rate limitation may be appealed to the State Tax Commission. In Colorado and New Mexico, the State Tax Commission must approve an increase in local levies of more than 5 per cent. And in California a local expenditure increase greater than 5 per cent must either be approved by the State Board of Equalization or be submitted to a referendum vote. In all four states, when the state review does occur, it appears to be rather perfunctory. In North Carolina a state Local Government Commission reviews proposed local bond issues.

State administrative receivership for financially embarrassed communities, described later in this volume,¹⁸ constitutes a special form of state control of local finances.

County control of local finances

Finances of local units are subject to review by special county boards in Indiana, Ohio, Oklahoma, and Multnomah County, Oregon. New Mexico has established a system of county budget commissions to review local school district budgets.

Members of the Indiana and Ohio reviewing boards are *ex officio*. Those on the Oklahoma boards are two-thirds appointive and one-third *ex officio*—one is a member selected by the state tax commission, one a judicial appointee, and the third the chairman of the county governing board.

With county supervision, the task of controlling local finances breaks down into practicable units. A county control board can become intimately familiar with the financial problems of the governments under its jurisdiction, thereby laying a foundation for intelligent and effective control. Evidence of what can be done along these lines are the accomplishments of the Tax Conservation Commission of Multnomah County. And such control does not outrage the sentiment for local self-government.

But county control boards lack the prestige of state bodies; local officials often treat them with petulant resentment. And they are more susceptible than state bodies to local pressure. Should they resist such pressure, their power can readily be shorn by reducing

¹⁸ See p 674 of this volume

appropriations. County control boards may perhaps serve a worthy purpose while the public is being educated to the need for effective state control of local finance. In themselves, they certainly are not an ultimate solution of the problem.

NONOFFICIAL PROMOTION OF GOVERNMENTAL ECONOMY

While institutional mechanisms—budget systems, state and county control of local expenditures, and the like—help the fight for governmental economy, they are but tools, and must be directed and kept in repair by outside forces. One of these outside forces is the taxpayer, who bears the burdens of governmental waste, extravagance, and graft. Another is the “career” official, professionally interested in successful accomplishment of the functions for which he is responsible.

Rarely does the individual taxpayer have the inclination, the time, the technical understanding of governmental finances, and the political or public influence to act as a guardian of his own and other taxpayers’ interests. But what is beyond the capacities of an individual may be accomplished by many taxpayers acting in conjunction as a “pressure group.” And programs of administrative improvement that would be beyond the power of state and local officials acting as individuals may be undertaken by state, regional, and national associations of such officials.

Taxpayers associations

Outstanding among the economy “pressure groups” are the taxpayers associations.¹⁹ A survey in 1927 discovered twenty-four state and nineteen local taxpayers associations. In 1937 eighteen active state associations and thirty-seven active local organizations were re-

¹⁹ The National Tax Association, organized in 1907, is not to be confused with the taxpayers associations described in the text above. This association, through its annual conferences, provides a forum where tax administrators and tax scholars can exchange views and information. By concentrating the attention of its members on desirable fiscal reforms, it has proved a potent force for fiscal progress in the United States. The published reports of the proceedings of its annual conferences and the files of its monthly *Bulletin* constitute an invaluable library of fiscal information.

ported. Hundreds of such groups have been established since 1920, but the mortality has been high and only the effective ones survive.

Taxpayers associations are supported by voluntary contributions—either fixed in amount or proportioned to taxes paid—from their members. With the funds so raised, a paid secretary is employed to attend budget hearings, analyze expenditure and taxation projects, publicize the policies and findings of the association, and lobby in the interest of public economy. A few of the larger state associations, of which the California Taxpayers Association is an outstanding example, maintain permanent research staffs, and make extended studies into the finances of their state and local governments. Some, like the Indiana association, have built up an effective structure of county and municipal subcommittees or subassociations which, with the advice and assistance of the central organization, work on problems of local finance.

Taxpayers associations may be divided into two classes on the basis of their purposes. The first class, which includes most of the larger and more successful associations, confines its attention to governmental expenditures and seeks to prevent extravagance and graft. The second type concerns itself not only with governmental expenditures but also with taxes and their social aspects. Associations of this second type often meet with dissension among their own members because of divergent views on tax policies, and eventually this leads to their disruption.

Bureaus of municipal research

Efficiency in city government is promoted by a special type of civic "pressure group"—the bureau of municipal research. The first of these organizations was formed in New York City in 1906 under the name "Bureau of Civic Betterment," and reorganized a year later with the name "Bureau of Municipal Research."²⁰ On this occasion it stated the following objectives, which have since become established as the program for bureaus of municipal research all over the country:

²⁰ In 1922 the New York Bureau was again reorganized, as the National Institute of Public Administration

- (1) to promote efficient and economical government,
- (2) to promote adoption of scientific methods of accounting and reporting details of municipal business, with a view to facilitating the work of public officials;
- (3) to secure constructive publicity in matters relating to municipal problems;
- (4) to collect, classify, analyze, correlate, interpret, and publish facts on the administration of municipal government.

The outstanding accomplishments of the New York Bureau of Municipal Research stimulated the creation of similar bureaus in other cities. One was established in Philadelphia in 1908, a third in Cincinnati in 1909, a fourth in Chicago, and in rapid succession still others in other cities, until now there are over sixty.

Most bureaus of municipal research are independent organizations, financed by voluntary contributions. A few receive their support from community chests, some operate as departments of chambers of commerce or boards of trade, and some are financed by the treasuries of the cities they serve. Like taxpayers associations, their main effort is to cooperate with the elected and appointed officials of their communities. Only in extreme cases do they appeal to public opinion against these officials. By giving city voters unbiased facts on the conduct of city government, and through adroit use of publicity, they have contributed profoundly during the past thirty years to the improvement of municipal government.²¹

Professional administrators' associations

Mutuality of interests on the part of officials engaged in identical or similar public activities has stimulated the formation of a number of national "public professional" associations. One of the oldest and most active is the Municipal Finance Officers Association of the United States and Canada, which was formed in 1906. A score or more of such associations are now in existence—among them, to mention but a few, the International City Managers Association, the

²¹ Governmental Research Conference, *Twenty Years of Municipal Research* (New York, 1927), David B. Truman, *The Educational Functions of the Municipal Research Bureaus* (University of Chicago, Chicago, 1936)

National Association of Purchasing Agents, the National Association of Assessing Officers, the American Public Health Association, the American Society of Municipal Engineers, the International Association of Chiefs of Police, the International Association of Public Works Officials.

To a considerable extent these organizations are social societies—their annual conventions provide their members with a pleasant yearly junket and opportunity to meet other individuals “who speak the same language.” But to an increasing degree, these associations are becoming agencies of improvement, reform, and progress in their respective fields. Individuals and committees conduct serious research into topics of interest to the membership of the associations, and the resulting reports frequently become milestones of accomplishment in their particular fields. Of course, since each association is interested in promoting the growth of its own professional field, their influence is towards expansion rather than contraction of governmental functions. By promoting efficiency in their respective fields, however, they frequently accomplish highly commendable economy in the employment of public funds. Many of the recommendations for fiscal improvement that appear in this volume are derived from reports of the various “public professional” associations.

Other economy “pressure groups”

Governmental waste and extravagance, particularly in the state field, add to the tax burdens of business. So the state and national business associations, among their other activities, keep a watchful eye on governmental expenditures and are active in promoting public economy. In this group are the National Association of Manufacturers, the United States Chamber of Commerce, the American Bankers Association, the National Association of Real Estate Boards, as well as the state chambers of commerce, the state manufacturers’ and merchants’ associations, and the state and local real estate boards.

CHAPTER VII

Government Enterprises

STATE grain elevators, the Alaskan railway, county airports, city waterworks and electric light systems, and other government enterprises involve substantial capital and operating expenditures. Unlike the public functions studied in the preceding six chapters, however, their operations produce income—usually somewhat less than their overhead and operating costs, occasionally greater. As we shall see, government enterprises fit smoothly into the general theory of public functions and expenditures, but, since their revenue-producing aspect raises special problems, it is advisable to give them special consideration.

GENERAL CONSIDERATIONS

In Chapter I it was established that the theoretical justification for any public function is its inherent element of indivisible social benefit. Specific individual benefits are but incidental by-products. If these incidental individual benefits are measurable, the beneficiaries may be called upon to pay for them. But such payment is not an essential element of ordinary public functions—in fact, one criticism of the American system of fees and charges made in Chapter XXIV is that our state and local governments unnecessarily ignore this source of revenue.

But in the case of government enterprises, the emphasis is inverted. Specific individual benefits overshadow the general social benefits—the latter rather than the former assume the status of by-product. To every shipper who uses a state canal, its transportation facilities are of measurable value; incidentally, the agriculture, commerce, industry, and general economic well-being of the state are furthered. A municipal water system supplies water of measurable

value to each individual and industrial user; over and above this private benefit is the maintenance of the community's living and sanitary standards. A city electric light plant likewise purveys to individuals, socially, it may save these same users—considered as a community—from exploitation by a private utility system too powerful to be subjected to effective regulation.

1) Scope of government enterprise

"Social benefit" may be a general argumentative justification for government enterprises. But it no more contributes a criterion for the proper scope of government enterprises than it does for the sphere of public functions generally. An extreme collectivist would assert that the elimination of private profit is sufficient social benefit to justify the complete supplanting of private enterprise by government enterprise. An extreme individualist would deny, and just as reasonably, that any social benefit inheres in the postal system's distribution of direct-mail advertisements and love-story magazines at less than cost. He would insist that the postal system be turned over to private enterprise and be operated for private profit. Categorical assertion and categorical denial are matched against each other. Once again, economic theory is unable to provide a yardstick for concrete action, and the issue must be left an open battle between opposing political faiths and prejudices.

Many special justifications have been advanced at various times in support of particular government enterprises. Upon analysis, however, they turn out to be but variants of the "social benefit" idea. They no more prove a case for government enterprises than the opposing categorical denials establish a case against. As bases for action these arguments can be ignored; as an important element in our fiscal literature, they deserve analysis.

Two arguments which still occupy considerable place in foreign literature on government enterprises have little current application in the United States. Projects too large to be encompassed by accumulations of private capital in "young" countries, it is argued, must be undertaken by the government. This justification, advanced in support of canal construction by the American states dur-

ing the second quarter of the nineteenth century, appears today in Canadian and Australian literature on public utilities. But a resurrection of the "paucity of private capital" argument in twentieth-century United States would be ridiculous, since the present investment banking structure is quite capable of focusing billions of dollars of capital on any undertaking which holds out promise of profit. Our writers on government enterprises have sensibly made no use of it.

German and French writers frequently point out that government ownership and operation of railroad, telegraph, and telephone systems in those countries permit lines to be so planned that they will contribute to offensive and defensive strategy in time of war. Fortunately the specter of war and invasion does not forever haunt the United States. Economic, not military, considerations have dictated the routing of our transportation and communication facilities. But we must not overlook the fact that naval strategy—unification of the defense of our Atlantic and Pacific coasts—was a prime factor in the building of the Panama Canal by the federal government.

The argument which is the mainstay of American proponents of "public ownership" turns upon the consideration that only a governmental unit is in a position to purchase a social benefit by sacrificing profit.

Even when private business or industrial activity is in the category of public service activities, such as transportation, communication, or the distribution of water, gas, or electric power, it must be permitted to charge rates which will net a reasonable return upon its investment. Often, however, some factor of general public benefit runs directly counter to the desire for profit. Private enterprise may find no profit in conserving natural resources for future generations. To encourage the free use of water, it may be socially desirable to charge a special low water rate in slum districts. It may be advisable to transmit newspapers and other publications through the mails at less than cost to encourage the dissemination of knowledge through printed matter. City growth may be furthered by running a car line into an unsettled suburb despite the heavy expense and the certainty of a net loss for several years. Private enterprise,

realizing that its prosperity depends in the long run upon community development, may sacrifice high present profits for larger future profits, but it can never discard the profit standard outright. In the operation of an enterprise touched with a public interest, only a government can put public purpose before profit, since it can meet deficits out of tax funds.

Several new arguments, turning upon peculiar current situations, have been developed in recent years in support of particular government enterprises. State monopolies of liquor distribution, in Canada and in sixteen American states, are based on the doctrine that a government can limit the production and consumption of a socially pernicious commodity by directly engaging in such business. Prior to the Federal Power Act of 1935, the extension of public ownership of electric power systems was frequently advocated on the ground that holding company tie-ups of public utilities had progressed beyond the point where they could be controlled by state regulatory bodies. Public ownership of utilities, it was contended, was the only means to safeguard the consumer against exploitation. Closely allied is the argument, advanced not long ago in support of the TVA power program and of a proposed New York City power station, that such government enterprises will provide a yardstick to determine what rates private utilities shall charge.

Finally, we occasionally meet the proposition that a government may reduce the tax burden by operating an enterprise to yield a net revenue. That is the primary basis for the European tobacco monopolies, and the argument has been advanced in this country as supplementary support for state monopolies of liquor distribution. Occasionally a "taxless town" boasts that its electric power plant yields such a substantial net revenue that property tax rates have been abolished. Upon examination, however, this "revenue justification" of government enterprises appears particularly weak. A net revenue is generally obtained only by sacrificing social objectives of greater importance. The point has been made, and soundly, that the European countries would probably obtain larger revenue and enjoy a better product if tobacco manufacture were left to private enterprise and commodity taxes imposed on the output.

The "relative efficiency" issue

Throughout the controversy over government enterprises, the principal charge brought against them is that they operate less efficiently than private enterprises, giving rise to a net economic loss which more than offsets any social benefit. Government enterprises, say the opponents of public ownership, are not compelled to explore every avenue of economy and efficiency since they are under no compulsion to produce more profit for an exigent group of stockholders. Furthermore, the management of a government enterprise frequently owes its office to political influence, and the malignant shadow of politics is ever present. Bureaucratic organization—in- evitable under political management—means "red tape" and inflexibility in the face of changing conditions.

Proponents of government enterprises insist that the charge of politics is overdrawn. Some enterprises have suffered on this score; many more can boast of their freedom from political interference. And still greater independence is gained by the creation of independent corporate entities, like those recently established by the federal government, for the operation of public enterprises. Managers of such government enterprise corporations stand on the same footing as managers of private utility corporations. Moreover, bureaucratic inflexibility in government enterprises is more than matched by bureaucratic inflexibility of entrenched private utilities whose monopoly positions are buttressed by long-term franchises.

Fair comparison of the operating efficiency of public and private enterprises is difficult. Since a government enterprise may deliberately forego profit in the interest of a social benefit, earning and profit standards cannot be applied. Unit costs also fail as a yardstick. In the utilities field, the natural difficulties, and hence the costs of production and distribution, vary from locality to locality and from enterprise to enterprise. Then, too, for the sake of ultimate social benefit, a government enterprise may deliberately assume certain costs which a private enterprise would avoid, such as running pipes or transmission lines to isolated or sparsely settled

neighborhoods. And finally, cost items included by a private utility, such as taxes and interest on a bonded debt, may be excluded from the calculations of a government enterprise.

Probably the comments made about government activity in general in the opening paragraphs of Chapter V—that its best is above the standard for average private business, that its average is below the standard for the best of private business—would apply to the field of government enterprises. Although this does not answer the question, “Are government enterprises more or less efficient than corresponding private enterprises?” the factual information available does not permit of any other fair answer.

Profit policy of government enterprises

Should a government enterprise be run at a loss? Should it just cover costs? Should it earn a profit?

No uniform principle applies to this issue. Whether a government enterprise should earn a profit or incur a loss must be determined by its nature and the surrounding circumstances. Where, as in sixteen states, a state operates a liquor sales monopoly to restrict consumption through limited sales and high prices, the enterprise should earn large profits. Where a government seeks to encourage the circulation of newspapers and other printed material by low mailing costs, the mail service must necessarily incur a deficit. Government enterprises, as we noted a few pages back, are primarily justified by some element of general public benefit; fiscal considerations are secondary. And the public must pay for this benefit by sacrificing operating profits and even by paying off operating deficits.

Since American government enterprises are usually founded because private initiative cannot yield the same general public benefit and still earn a profit, it should follow that most government enterprises earn no profits. It is well known that the postal system, the Emergency Fleet Corporation, and several other services have incurred deficits which the federal government has met out of its general revenue. Operating expenses and revenues of state enterprises,

exclusive of liquor monopolies, balanced at \$19,800,000 in 1938. In the same year, operating expenditures of municipal enterprises in cities with populations over 100,000 were \$454,000,000, as contrasted to their gross income of \$421,000,000.

State and municipal enterprises would show even larger deficits but for certain peculiarities in accounting procedure for government enterprises. State and municipal enterprises, with few exceptions, are established with borrowed money, but instead of charging the interest on such loans against the gross income of the enterprise, it is frequently paid out of general government funds. Moreover, government enterprise accounts do not always allow for the amortization of capital debt, and principal as well as interest may be paid out of the general funds of the government. Finally, when such enterprises operate under private ownership, they are subject to heavy taxes, as government enterprises, however, they are usually exempt. Against these three items of concealed expenditure must be set an item of concealed income. Government enterprises, particularly those providing water, gas, electric power, generally serve other governmental departments without charge. Despite this item of concealed income, however, it is probable that were concealed expenditures taken into account, many more municipal and state enterprises would show a net deficit instead of a net profit on current operations. In individual cases, of course, government enterprises do yield a true net revenue to their governments.

Deficit operation of a government enterprise, it must be emphasized again, is ~~not per se a cause for criticism~~. When the enterprise gives rise to a valid social benefit, the community pays for that benefit by covering the deficit out of general tax funds. But no worthy purpose is served by using tricky accounting practices to conceal the deficit. Public enterprises should count interest on capital debt as a cost, even when the governmental units behind them issue the bonds and pay the interest on them from general funds. Depreciation and obsolescence reserves, identical with those which a comparably situated private enterprise would establish, should be maintained. These overhead costs can no more be ignored by a government enterprise than by a private enterprise. Their omis-

sion from the accounting setup falsifies the picture that taxpayers and consumers of the enterprise's services should have.

Frequently the deficit operation of government enterprises is condemned for shifting a cost burden from consumers of the services to taxpayers. Of course, a cost burden is shifted from the one group to the other. But while such shifting does take place, it is not necessarily a matter for condemnation. To the extent that the enterprise contributes to the general public welfare as well as provides a service for individual customers, such shifting is warranted. Both taxpayers and users owe some contribution to the creation and maintenance of a municipal ferry or toll bridge which binds a city into a more cohesive unit, facilitates its development, widens it as a market, enhances property values. Were a schedule of charges to cover all costs, it would shift onto the users a burden more properly belonging on the taxpayers. Only where it can be shown that no general benefit accrues to the community as a whole, where all benefit redounds exclusively to the customers of the enterprise, is there a clear case for covering all costs out of charges.

Government enterprise charges

Government enterprises may charge either "prices" or "rates." A "price" is identical for government and private enterprise; it is a charge per unit of material sold or service performed. A "rate," unlike a "price," is based on some circumstance other than the unit of material or service.

Whether the charges should be in the form of "rates" or "prices" depends upon the character of the particular enterprise. The federal postal service is operated on a "price" basis. Municipal gas and electricity is usually metered as it is delivered to individual consumers, and a "price" is charged for the supply. Municipal water systems, however, may be financed by "rates." Instead of installing meters, a flat charge is made per house, or per family, or per faucet in each house. Such water rates are graduated, as a rule, according to whether the water is used for personal consumption or for industrial operations. A rate system has the advantage of saving the cost of metering, but fails to apportion the charge directly to use.

Incorporation of government enterprises

Traditionally, government enterprises have been operated under departmental authority. Their activities are subject to legislative control like those of any other administrative function. Their personnel is part of the general personnel of the governmental unit, and subject to the same civil service and salary regulations. Their finances are part of the general finances of the unit, and are subject to the regular pre-audit and post-audit.

A number of early federal enterprises could not follow this tradition. The First and Second United States Banks obtained their capital from private investment as well as from the federal government, and were established as federal corporations. The same arrangement, for the same reasons, was worked out for institutions of the federal farm credit system. In acquiring properties and rights necessary for the building of the Panama Canal, the War Department obtained a complete operating corporation, the Panama Railroad Company; the corporate entity of this enterprise was retained. The Wilson Administration found it advisable to incorporate a number of its special war agencies—the War Finance Corporation, the Emergency Fleet Corporation, the U. S. Grain Corporation, the U. S. Housing Corporation, and others. By incorporation, these agencies obtained the important advantage of flexibility of policy and freedom from administrative “red tape.” Most of them were liquidated during the early postwar years.

When the Roosevelt Administration inaugurated its program of federal credit insurance and power enterprises, it found the corporate form well suited to its plans. Incorporated enterprises would be relatively free of Congressional interference after their initial establishment. With their independent capital structures, such corporations, while accountable to Congress for their operations, would not be beholden for annual appropriations. They would possess somewhat the same freedom of operating, personnel, and financial policy as private incorporated enterprises. Managerial and personnel control could conform to business principles instead of to government administrative routine, which may be sound procedure for ordinary

governmental functions but be hampering in the enterprise field. Another important consideration, these corporations would not be subject to the legalistic auditing procedure of the General Accounting Office,¹ but could have independent commercial audits.

There was no uniformity among these New Deal enterprises as to method of incorporation or type of corporate structure. Eight were incorporated in Delaware, whose liberal laws allow the greatest freedom of corporate action. Three were incorporated in the District of Columbia, two in New York, and one each in Washington, Connecticut, Tennessee, and Maryland.

The general judgment is that the decision to set these federal enterprises free of political control by incorporating them was a happy one. One authority makes the generalization that incorporation of government enterprises is desirable whenever they "possess one or more of the following characteristics: (1) intimate business contacts with individuals and companies in rendering them goods or services for which unit payment is made upon receipt rather than through lump-sum payment of taxation; (2) self-liquidation, or an approximate balance of nonappropriated income with expenditures; (3) competition with private businesses, especially when a 'yardstick' for determining costs is intended."²

State and municipal governments so far have not generally endowed their enterprises with the quasi-independence of incorporation. The Port of New York Authority and the North Dakota Mill and Elevator Association are incorporated state enterprises, and the Boston Elevated Railways is an incorporated municipal enterprise, but these cases are exceptions. There are no valid reasons why state and local enterprises should not profit from the advantages of incorporation, and it may be that federal procedure during the past half decade will open the way to a new chapter in government enterprise operation.

FEDERAL ENTERPRISES

Until recently, the federal government evinced little interest in establishing and operating enterprises. The postal system, which

¹ See p. 155 of this volume.

² John McDermid, *Government Corporations and Federal Funds* (University of Chicago Press, Chicago, 1938), p. 209.

dates from the first years of the republic, was long viewed as a sovereign rather than a commercial function. With the possible exception of the Alaska Railroad, the various federal enterprises established between 1900 and 1933—the Panama Canal, the reclamation projects, the Shipping Board, the Inland Waterways Corporation, and wartime operation of the railroads—were by-products of other interests. In the decision to build and operate the Panama Canal, naval defense was a primary consideration. Reclamation projects were an offshoot of the much broader problem of the disposal of the public domain. Federal ventures in foreign and inland shipping and in railroad operation were originally incidental to the mobilization of national economic resources for greater wartime efficiency.

Since 1933, however, under "New Deal" auspices, the federal government has deliberately "gone into business"—power development and distribution, housing, credit, insurance, the merchandising of electrical equipment. This revolutionary shift in federal policy has made the issue of "public ownership" one of immediate moment.

The postal system

Congress was specifically given the power "to establish post offices and post roads" under Art. I, sec. 8, § 7, of the Constitution, and exercised it soon after the federal government was organized. The postal department was the fifth federal administrative division to be established. Placed on a permanent basis in 1794, it took over the rather informal postal system that had been in operation since colonial times.

During the first fifty years of operation the Post Office Department earned moderate surpluses; from 1841 to 1934, it avoided deficits in only eleven years. Postal surpluses were checked in 1845 by the reduction in rates and the extension of the service. The surpluses of 1849, 1850, and 1851 disappeared when the letter rate was reduced from five to three cents per half ounce. When surpluses again developed in 1882 and 1884, the letter rate was dropped to two cents per half ounce, and subsequently to two cents per ounce. On other occasions, possibilities of profit have been foregone in order to expand the service along new and often costly lines. Railroad mail was

established as soon as locomotives and cars showed they could cling to rails. The registry service was organized in 1855. Urban free delivery was introduced in 1863, and the money order system began in the year following. Postal cards were authorized in 1873. Started in an experimental way in 1896, rural free delivery expanded rapidly. The postal savings system went into effect in 1911. Parcel post was added to the service in 1913. In 1918, a tentative beginning was made at air mail service. Only two branches of the postal service—first-class mail and postal savings—normally yield a profit; it is interesting to note that the loss on second-class mail normally just about balances the profit on first-class mail.

Ample evidence has been submitted on numerous occasions to show that many details of postal operation are marked by gross mismanagement. Political appointment to certain grades of postmaster-ships prior to 1938 were a constant open invitation to inefficiency. Excessive rentals paid for post-office premises suggest an unwholesome touch of graft. And lax accounting methods involve the system in countless petty losses. But to attribute the persistent deficits of the postal system to these and other elements of mismanagement, as many critics have done, is one-sided reasoning. At any time from 1841 on, with even more inefficiency than could fairly be attributed to it, the postal department could have earned profits by maintaining high rates or by limiting operations to profit-yielding lines. Instead, it chose to sacrifice profit for various indirect social and national benefits. In the interest of popular education, it has subsidized newspapers and magazines by distributing them at less than cost. It subsidized railroads and airlines during their developmental periods by grants of more-than-cost mail contracts. From the close of the Civil War until the passage of the Copeland Shipping Act in 1936, mail subsidies were a substantial factor in maintaining the skeleton of an American merchant marine.

There should be no relaxation in the campaign for greater postal efficiency. That is a desideratum *per se*. But the issue of efficiency should not be confused by drawing in the red herring of postal deficits. Postal profit or loss is determined as much, if not more, by extraneous rate and subsidy policies.

Transportation enterprises

The federal government has made six ventures into the transportation field—three apparently permanent, and three temporary in character.

Outstanding among these six enterprises is the Panama Canal. A canal across the Central American isthmus, as was recognized far back in the nineteenth century, would be of tremendous benefit to American and world trade and to American shipping—in fact, an isthmian canal was the subject of treaty between England and the United States in the 1850's. By the twentieth century, American investment banking institutions were capable of bringing together the capital needed for such an enterprise, and a private corporation probably could have constructed and operated a Panama canal at a profit. But international issues and the potential relation of an isthmian canal to American programs of naval defense made a private undertaking inadvisable. So the federal government acquired the Canal Zone, bought out the moribund French company which had been digging there, and started construction on the Panama Canal. By 1921 a half billion dollars had been invested in the enterprise.

Even the severest critics of government ownership have bestowed unqualified praise on the construction and operation of the Panama Canal. Efficient operation being unanimously acknowledged, profit or loss turns upon the rates charged, and these are determined by Congress. The rates which have been set return a revenue ample to cover all costs of operation plus a meager maintenance allowance, and yield somewhat less than a 3 per cent return on the federal government's capital investment.

Incidental to the operation of the Panama Canal, the federal government also maintains a Panama Railroad. Well handled under independent corporate setup, this small line returns a steady moderate profit. On the other hand the second federal railroad, the Alaska line, operates consistently at a loss. Built by the federal government between 1914 and 1921 at a cost of \$52,000,000 because the impossibility of deriving any profit from such an enterprise in the near future precluded the application of private capital, the road rep-

resented a federal investment in the development of Alaska. Motor highways now serve much of the territory covered by the railroad, and have appropriated considerable part of the traffic it was originally expected to carry.

On December 26, 1917, the federal government took over the nation's railroads, and operated them for twenty-six months thereafter at a cost of \$1,123,500,000 in immediate deficits, and another \$530,000,000 subsequently paid on claims arising out of federal operation. Opponents of government enterprise point to this record as an outstanding indication of failure, but the criticism is hardly fair. The federal government commandeered the railroads only because they had failed to achieve under private operation the continent-wide coordination of service necessary to the success of the government's war plans. For twenty-six months railroad lines were a branch of the combative service and a subsidiary instrument of demobilization, and their regard for costs was but incidental. Furthermore, while rates remained unchanged, railroad wages were raised as the cost of living mounted, and materials and equipment were bought at the prevailing inflated prices. Privately operated, the railroads could not have done what they did under government operation—sacrifice every other consideration to wartime service. An outstanding transportation authority, no advocate of government ownership of the railroads, considers that

it is difficult to understand how the railways of the country could have been operated with maximum efficiency and with minimum injury for the future except as they were. . . . Federal operation may not have been an entire success but when judged upon the basis of its accomplishments and failures, the obvious defense is that results might easily have been less satisfactory under any other plan.³

Shipping operations of the federal Shipping Board and its subsidiary, the Emergency Fleet Corporation, were likewise a wartime expedient. Unlike federal railroad operation, however, federal shipping activity could not be liquidated immediately after the war. By

³ Sidney L. Miller, *Inland Transportation* (McGraw-Hill Book Co., New York, 1933), p. 168.

1922, federal shipping agencies had contracted for 2,311 vessels, totaling 13,625,311 tons, a fleet greater than had ever been controlled by any other organization or government in the history of world shipping. Although the Shipping Board would gladly have disposed of its fleet and wound up its affairs, it could not because the market was glutted. To preserve the ships from becoming sheer junk, and to conserve an American merchant marine against such time as private operation might be able to take over the responsibility, the Board had to continue as a shipping operator. Under such circumstances, heavy operating deficits were inevitable; they continued through the 1920's and early 1930's.

The Inland Waterways Corporation involves considerations not present in the five other federal transportation enterprises. Federal inland water transportation began during World War I as a minor effort—barge lines operated on the Mississippi River and New York barge canal—on the part of the War Department to relieve railroad congestion. In 1924 it was decided to enlarge the enterprise as an experiment “to demonstrate . . . the practicability of inland water transportation as a field of private investment.” Some barge routes were discontinued, some old and some new routes were turned over to a federal-owned corporation—the Inland Waterways Corporation. Taking into account all special assistance by the federal government, the Inland Waterways Corporation has been a costly enterprise, none too efficiently operated.⁴ The case for its continuance is weak. Most students of the American transportation problem feel that present inland waterway traffic is economically inferior to alternative railroad and motor vehicle transport. Any benefits to shippers of the corporation's less-than-cost service are offset by the loss of railroad revenues from this traffic.

Power enterprises

Federal activity in the power field is in a preliminary stage. Three great river systems are being harnessed by the federal government for the production of hydroelectric power. Work is still proceeding

⁴ For a contrary view, see John McDiarmid, *Government Corporations and Federal Funds* (University of Chicago Press, Chicago, 1938), p. 55.

on dams in the Tennessee River Valley, on the Colorado River, and on the Columbia River. These projects embrace flood control, irrigation, and land reclamation, as well as hydroelectric power development; indeed, power production is more or less a by-product. All the same, when the power houses associated with these projects are completed, they will add substantially to the nation's power supply.

From the outset, controversy raged around the power features of the Tennessee Valley project. Proponents of the project stated, as one of the arguments for it, that it would provide a "yardstick" for measuring the efficiency and rate charges of private power companies. Representatives of private utilities retort that fair comparison will be impossible, because the fraction of total capital costs being allocated to the power elements of the project is inadequate, and because the federal enterprise will be free of the taxes borne by private companies. Where, under the torrent of charges and countercharges, the truth lies submerged cannot be ascertained at the present preliminary stage of the project.

Settlement and resettlement enterprises⁵

In 1902 a Reclamation Act set aside the proceeds from the sale of public lands in sixteen designated states as a revolving fund for irrigation projects. Projects financed from this fund were models of sound engineering, and 700,000 people today live and find their livelihoods in the areas thus irrigated and reclaimed. But the resources of the revolving fund could not cover the cost of these undertakings, and additional revenues had to be voted. Sales and water service contracts had to be readjusted as a result of the difficulties encountered in collecting instalment payments from the settlers. Some \$15,000,000 of loss was written off in 1926; further losses will have to be taken in the future.

Part of the Roosevelt "recovery program" was the appropriation of \$350,000,000 to the Resettlement Administration. Some of this appropriation was to be utilized for the removal of farm families from submarginal lands and their resettlement in areas of better economic opportunity. Resettled families, according to the original intention,

⁵ General disposal of undeveloped public domain is considered in Chapter XXIV.

TABLE 13

FEDERAL INVESTMENT IN INCORPORATED FEDERAL ENTERPRISES,¹ 1931-1941

(Amounts in millions)

| Enterprise | 1931 | 1933 | 1937 | 1941 |
|--|-------|---------|---------|---------|
| War and defense agencies | \$11 | \$11 | \$8 | \$32 |
| <i>Transportation</i> | | | | |
| U S Maritime Commission | \$217 | \$224 | \$87 | \$161 |
| Panama Railroad Co | 42 | 43 | 44 | 52 |
| Inland Waterways Corporation | 24 | 25 | 25 | 24 |
| Power (TVA) | . | . | \$64 | \$326 |
| <i>Agricultural credit</i> | | | | |
| Farm Credit Administration | \$392 | \$555 | \$191 | \$ 66 |
| Farm credit banks | 34 | 168 | 671 | 518 |
| Regional agricultural credit corps | | 150 | 27 | 21 |
| Federal Farm Mortgage Corporation | | | 176 | 100 |
| Farm Security Administration | | | 128 | 385 |
| Rural Electrification Administration | | . | 13 | 117 |
| Commodity Credit Corporation | . | .. | 123 | 100 |
| <i>Home Credit</i> | | | | |
| Home loan banks | . | \$43 | \$121 | \$125 |
| Home Owners Loan Corporation | | | 68 | 108 |
| Federal Housing Administration | | | 30 | 64 |
| U. S Housing Authority | | . | | 137 |
| Other | | 1 | 48 | 42 |
| <i>Other credit</i> | | | | |
| Reconstruction Finance Corporation | | \$1,498 | \$1,539 | \$557 |
| Export-Import Bank | | . | 18 | 184 |
| <i>Insurance</i> | | | | |
| Federal Deposit Insurance Corporation | .. | .. | \$108 | \$150 |
| Federal Savings and Loan Insurance Corporation | .. | . | 150 | 129 |
| Miscellaneous | \$40 | \$52 | \$304 | \$198 |
| Total | \$760 | \$2,770 | \$3,943 | \$3,596 |

¹ Exclusive of the postal system, the Panama Canal, the Alaska Railroad, and the Colorado River and Columbia River projects, which are not handled by government corporations.

Derived from United States Secretary of the Treasury, *Annual Reports*.

were eventually to repay the government for its expenditures. But costs have so far outrun the original estimates that the federal government, it is now evident, will have to charge off a considerable fraction of such expenditures to "general relief and recovery."

Credit enterprises

Twice during its first thirty years, the federal government participated with private capital in establishing commercial banks. In 1791 the federal Treasury subscribed \$2,000,000 of the \$10,000,000 capital of the First United States Bank, in 1816 it subscribed \$7,000,000 of the \$35,000,000 stock of the Second United States Bank. Both investments were profitable. But the federal government has made no other investment in commercial banks. Although Congress has legislated extensively upon banking, has established the national and federal reserve banking systems, it has not authorized the federal government to engage or participate in commercial banking.

Other credit fields, however, have been entered by the federal government. In 1916 a federal land bank system was established. Private capital was expected to buy the shares and bonds of the land banks, but it was not forthcoming during the war years. The federal Treasury had to buy most of the securities to enable the land banks to start operations. In 1923 the Treasury subscribed the initial capital of the federal intermediate credit banks. Six years later a \$500,000,000 revolving fund was established to cover credit extensions to farm cooperatives. In 1932 the Treasury was directed to subscribe another \$125,000,000 to the stock of the federal land banks, and the Secretary of Agriculture was given \$200,000,000 for direct loans to farmers. Several new agricultural credit agencies—the Farm Mortgage Corporation, the Commodity Credit Corporation, the Electric Home and Farm Authority, the production credit corporations, and the banks for cooperatives—were created in the reorganization of the federal farm credit system during 1933 and 1934. Some were temporary organizations and some permanent, but all were supplied with capital by the federal government. By 1937 the Treasury had invested over \$1,300,000,000 in farm credit institutions.

In similar fashion the federal Treasury has provided \$121,000,000

of the \$156,000,000 capital of the home loan bank system, established in 1932. It subscribed the entire \$200,000,000 capital of the Home Owners Loan Corporation, created in 1933. Most of the working capital of these institutions, however, was raised by the sale of bonds.

Most stupendous of all the "New Deal" credit enterprises was the Reconstruction Finance Corporation. Created in January 1932 to extend emergency credit to financial institutions and railroad corporations, it was enlarged by the Roosevelt administration and became the source of "shock funds" to stem financial collapse in all fields. It lent \$3,000,000,000 to commercial banks, over \$500,000,000 to railroads, and smaller amounts to insurance companies, municipal corporations, and industrial corporations. It advanced to the Treasury the sums invested in the capital stock of the agricultural and home loan institutions, as well as \$1,500,000,000 for relief outlays. The federal Treasury provided the original \$500,000,000 capital of the RFC and in addition bought the notes issued to obtain working capital.

In 1933 and 1934 it was freely prophesied that the RFC, as a government enterprise, would not exercise proper business discrimination in making its loans and investments, that many would not be repaid, and that the federal Treasury would eventually sustain heavy losses. The writing off of \$2,700,000,000 of its assets as uncollectible in 1938 might seem to lend color to this criticism, but these sums were relief advances to government agencies and had been viewed as outright grants at the time they were made. The time has not yet arrived when the validity of this charge can be estimated. As of December 31, 1940, \$6,481,000,000 of RFC's \$8,310,000,000 advances to private agencies had been repaid.

Insurance enterprises

Part of the program of financial reform incorporated in the Banking Law of 1933 was the provision for the insurance of bank deposits. The insurer would be the Federal Deposit Insurance Corporation, whose creation was authorized by the act. Of its capital, \$150,000,000 was furnished by the federal Treasury, the remainder partly by the federal reserve banks and partly by the commercial banks which

were to have their deposits insured. To insure the accounts of savings and loan associations, building and loan associations, and certain other institutions, similar provision for a Federal Savings and Loan Insurance Corporation was made in the Federal Housing Act of 1934. A further venture in federal insurance was made in 1938 with the creation of the Federal Crop Insurance Corporation, to insure wheat raisers against losses from extraneous causes.

Critics condemn the principle of deposit insurance, and the terms on which the FDIC and the FSLIC extend the insurance. They prophesy disastrous failure of federal enterprise in this field. Eulogists praise financial insurance as one of the soundest accomplishments of the "New Deal." This again is a controversy which time alone can settle.

STATE AND MUNICIPAL ENTERPRISES

In comparison with the scope of their general functions, state governments enter much less into the field of enterprise activities than either the federal or municipal governments. Partial explanation is the unfortunate state experience with banking, canal, and railroad enterprises during the 1830's and the 1850's. Another reason is the anomalous economic character of state areas—they have, as a rule, no relation to broad regional service needs, yet they are too extensive to provide local services effectively.

Early state enterprises

Most American states were enthusiastic investors in financial and transportation enterprises during the first half of the nineteenth century. They became majority or even sole stockholders of commercial banks. They built canals. They held shares in railroad companies. Between 1830 and 1836, state debt—practically all of which was incurred to finance these enterprises—increased from \$26,000,000 to \$175,000,000.

Of course, general public benefit was an important consideration in launching all these enterprises. But quite as important was the doctrine of "state capitalism" then current. States were urged to borrow, and invest their borrowings in profit-producing enterprises.

Dividends were expected not only to exceed the interest on the borrowed funds, but to provide in addition an investment income sufficient to cover current state expenditures. Upon the establishment of the Bank of Alabama in 1836, that state abolished its tax system; bank stock dividends, it was thought, would provide the state government with sufficient revenue to cover its expenditures.

Rude awakening came with the depression of 1837-42. Instead of distributing profits, the state-owned banks, canals, and railroads incurred deficits. Seven states defaulted on the interest due on enterprise bonds, two entirely repudiated their issues. Despite this experience, a number of southern and western states invested heavily in railroads and banks during the late 1840's and early 1850's. Several of these enterprises involved their state governments in heavy losses during the depression of 1857-60.

Most scholars who have studied pre-Civil War state enterprises agree that they were foredoomed to failure. They were undertaken as profit ventures by organizations absolutely unfitted for business activity. State governments were exclusively political organisms; administrative techniques simply did not exist. Politics dominated the establishment and management of most of these enterprises. In good years they might prosper in spite of maladministration. But they were badly geared to the economic order, and could not withstand the stresses of depression periods.

Current state enterprises

Sixteen states by 1938 had profitable liquor monopolies. Seven provided harbor facilities; the Port of New Orleans facilities, with annual receipts and costs in excess of \$5,000,000, is the largest present state enterprise. Two states operated canals.⁶ Irrigation projects, toll bridges, ferries, electric railroads, coal mines, cement plants, warehouses and grain elevators were among the other state enterprises reported in 1938. The liquor monopolies showed a profit of

⁶ Between 1903 and 1931, New York expended over \$175,000,000 in improving the old Erie Canal, and now maintains it as the New York Barge Canal. Since no tolls are charged, however, this canal cannot be counted as a state enterprise, but is to be considered a general state function, like the free motor highways

\$59,000,000. For other state enterprises, costs and receipts balanced at \$19,800,000.

Outstanding among state enterprise ventures in recent years have been those of North Dakota and South Dakota. At the behest of agrarian interests, North Dakota during the 1920's established a creamery, a grain elevator, a flour mill, a state bank with agricultural credit as its main field of activity, and—a sop to urban interests—a home-building program. Subsequently the state undertook to extend farm mortgage credit. In the same period, South Dakota embarked upon a rural loan system, state hail insurance, state bank deposit guaranty, the manufacture and sale of cement, coal mining, and gasoline distribution. In addition, it undertook the management of farm properties acquired by the state through foreclosure on rural credit loans, and operated by tenant farmers under lease.

There can be no question of the necessity for farm credit facilities in the Dakotas during the early 1920's. But, with the federal land banks and the joint stock land banks ready to extend credit where adequate security was forthcoming, the need for *state* farm credit is open to question. The farm credit systems of the Dakotas catered to the less desirable credit risks. Defaults and foreclosures were numerous. By 1933, North Dakota was saddled with over 500,000 acres of foreclosed land, and South Dakota was holding over 1,500,000 acres. State bonds issued to provide funds for the mortgage loans on these properties remained outstanding, of course—to be paid off out of general state revenues.

Most of the other Dakota enterprises had sorry records of failure. The capital cost of South Dakota's cement plant exceeded estimates, and construction was so long delayed that the plant could not fulfill its purpose—the provision of cement to be used in constructing state roads. Eventually it was wound up with an operating loss of over \$200,000 and a capital loss of about \$750,000. South Dakota's coal mine involved a loss estimated at \$185,000, and her attempt at gasoline distribution cost \$300,000. The state hail insurance and bank deposit guaranty were not managed on proper actuarial principles, and likewise involved loss. And in North Dakota the state bank, the flour mill, and the grain elevator all incurred losses.

The bare fact of loss operation is no condemnation of the Dakota enterprises. Had the two states purposefully planned to promote various public benefits with some element of cost to the state, the subsequent losses might be justified. Such was not the intention of either state, however, and the financial history of the enterprises is a clear record of failure. Many factors, some beyond the possibility of control or anticipation by the creators and managers, contributed to the failure of these enterprises. The deficit incurred by the North Dakota grain elevator and mill, for example, is attributable primarily to its having been financed by a 5 per cent bond issue, thus saddling it from the outset with a heavy fixed charge, and to depression problems that affected all business.⁷ But the outstanding cause of failure seems to have been the surrender of critical economic judgment to political pressure.

Municipal enterprises

Enterprises are rarely operated by counties, towns, and other units of rural government, but they are a common item of city government. In 1938, all but one of the 94 cities with populations over 100,000 operated enterprises.

Water supply systems account for nearly half the total investment and operating finances of municipal utilities. In this field, municipal ownership and operation overshadows private enterprise. According to a recent survey, 7,853 of the 10,789 water systems in the country are municipal enterprises.

In 1932, 1,800 of the country's 3,400 electric power systems were municipally owned—mostly by small cities. Half of these were both producing and distributing systems; the other half confined themselves to distribution only. But compared with the average private plant built to service a large area, the average municipal electric power plant is small. In 1932, the municipal plants produced only 6 per cent of the country's total power output. During the past decade, as a result both of indiscreet private utility policies and of the open encouragement of the Roosevelt administration, the field of

⁷ Gilbert W. Cooke, "The North Dakota State Mill and Elevator," *Journal of Political Economy*, Vol. XLVI, 1938, pp. 25-51.

municipal electric power enterprise has probably shown a slight extension, in contrast to the marked decline that occurred during the 1920's.

Among other instances of municipal enterprises may be noted the hundreds of airports established in recent years, the dock systems of New York, Los Angeles, Philadelphia, and a score of other cities, the New York City ferry system, some forty gas systems, street railway systems, a large number of bus systems, and occasional municipal toll bridges. The largest single municipal enterprise at the present time is the New York City subway system, representing an investment of about \$1,500,000,000 and with annual operating revenues approximating \$115,000,000.

PART II

PRINCIPLES OF TAXATION

CHAPTER VIII

Constitutional Aspects of Taxation

TAXES are levied through the agency of laws enacted by legislative bodies. Congressional power to enact tax laws for the federal government is prescribed by the federal Constitution. State legislatures are limited in their power to enact tax laws by the federal Constitution and by the constitutions of the several states. And the powers of local governments to levy taxes are granted by state constitutions and statutes, and are subject to the limitations of the federal Constitution, the state constitutions, and state statutes.

With the courts rests the ultimate determination of whether a tax statute is valid under federal and state constitutional limitations. Federal courts have the final word on the validity of a federal, state, or local tax law under federal constitutional limitations. State courts determine whether a state or local tax conforms with the limitations of a state constitution.

No matter how desirable from an economic, distributional, or administrative viewpoint, a tax may not be levied if it is held to contravene constitutional limitations. To understand American tax problems, therefore, involves an understanding of the constitutional principles underlying the levy of federal, state, and local taxes.

GENERAL LEGAL PRINCIPLES OF TAXATION

Certain basic legal principles of tax levy, more fundamental even than constitutional prescriptions or limitations, derive from the very character of government itself, or from the common law which antedates all American constitutions. A brief survey of these basic legal principles must precede an analysis of constitutional tax law.

Power to enact tax statutes

Unless forbidden by express or implied constitutional provision, tax laws may be enacted under two sovereign governmental powers—the tax power and the police power. Both powers are “inherent”—part and parcel of the concept of “the State,” and inseparable from it.

Definitions of the taxing power, in judicial decisions, in books upon constitutional law, and in books upon tax law, are in substantial agreement despite their diverse wordings. By definition, the tax power is the State’s sovereign power to exact contributions from persons¹ or to make levies upon property. Such power, however, is subject to three inherent limitations—(1) the revenue derived must be applied to “public purposes,” (2) the persons or property taxed must be within the jurisdiction of the State, and (3) the exaction must be “reasonably apportioned” among the persons or property subject to the tax.

“Inherent” taxing power and the three “inherent” limitations upon it, argue many legalists, pre-exist in every sovereign State, irrespective of constitutional grants and limitations of governmental powers. Other writers on constitutional law, refusing to concede “pre-existence” of the tax power and its “inherent” limitations, argue instead that both power and limitations must be construed into the constitutional document of any sovereign State. Despite the clashing first premises of these two lines of argument, the conclusions are identical—the government of every sovereign State is invested with the power to tax, and these three limitations apply whether or not they are covered by a constitutional document.

In the absence of constitutional limitations, the legislature’s powers to set tax rates are generally held to be absolute. Confiscatory rates would not invalidate a tax otherwise valid. This principle generally applies also to those license taxes on special occupations which are clearly exercises of the tax power rather than of the police power. Some state courts, however, will not permit the use of the tax power in a manner that amounts to a prohibition of a useful or legitimate occupation.

¹ Including corporations which, according to legal fiction, are “persons”

The police power may be defined as the power of a sovereign State to control persons and property within its jurisdiction in the interest of the general welfare. As indicated in a later chapter,² license fees levied to finance the cost of regulating a particular industry or occupation are based on the police power. Legal authorization for certain taxes producing a net revenue may also be partly found in the states' police power. It may, for instance, be desirable to restrict the performance of an act inherently harmless, but injurious to the public welfare if done too frequently. Instead of arbitrarily limiting the number of persons who may perform the act or the number of times it may be performed, a tax may be levied upon the performance of the act, and the desired result indirectly effected. The liquor license charges levied in most states can thus be justified as an exercise of both the police and the taxing powers. A number of state oleomargarine levies intended to discourage the competition of this food with butter, find their support in the police power rather than the tax power. In 1940 Kentucky enacted a chain store levy based explicitly on the state's police power, since a conflict of interpretations between federal and state courts made it impossible to enact a chain store tax under the state's tax power that would be sustained in both courts.

Governments, it is sometimes argued, may derive the right to levy certain taxes from specific powers other than the tax power and the police power. Thus the Supreme Court has held that Congress may levy customs duties as an exercise not only of the specific grant of this particular tax power in the federal Constitution, but also of its power to regulate foreign commerce.³ It has also been argued that Congress may impose a prohibitory tax on state bank notes as an incident of its power to regulate the currency.⁴ But it can be argued that the powers to regulate interstate commerce and currency are themselves merely specific phases of police powers granted to Congress under the Constitution. A protective tariff and a state bank

² Chapter XXIV, p. 592 of this volume.

³ *Hampton and Co. v. U. S.*, 276 U. S. (1928) 394; *Board of Trustees of University of Illinois v. U. S.*, 289 U. S. (1933) 48.

⁴ *Veazie Bank v. Fenno*, 8 Wall (1869) 533.

note tax, therefore, could be interpreted as exercises of a federal police power.

Inherent, designated, and delegated powers of taxation

The tax power having been described as an "inherent" power of "sovereign" governments, it is pertinent to inquire what American governments are "sovereign."

When the thirteen colonies threw off English sovereignty by the Declaration of Independence, they acquired the status of independent sovereign states. The Treaty of 1783 confirmed this assumption of sovereignty. As each new state entered the federal union, it acquired a standing coequal with those already members, and itself became sovereign. By historical premise, the forty-eight states are clothed with full sovereignty, and are therefore full masters of the "inherent" power of taxation. Checks to the exercise of their tax powers are the self-imposed limitations of their state constitutions and the limitations of the federal Constitution, which they accepted by ratification.

The federal government owes its existence to the federal Constitution. Such elements of sovereignty as it possesses were directly or by implication bestowed upon it by constitutional provision. Tax power is not "inherent" in such a limited sovereignty. Rather, like all the other powers of the federal government, the tax powers are designated by the federal Constitution.

A local government is merely an instrumentality of a state government, organized to perform specified governmental functions; it lacks independent sovereign status. It has only those attributes of sovereignty delegated to it by the state law under which it is organized. Among the powers delegated to local governments are their powers to tax. By immemorial custom, the creation of a local government carries with it, in some states, the delegation of tax powers. The constitutions of other states provide that the creation of a local government implies a delegation of tax powers. Still other state constitutions require that such delegation of tax powers be specifically expressed in the statute organizing a local government or a class of local governments.

Sometimes it is said that legislatures "delegate" certain tax powers to such administrative bodies as tax commissions and assessment boards, but this is a mistaken view. Sovereign tax power is a legislative attribute, and the legislature cannot delegate the determination of tax bases and tax rates to any other branch of the government.⁵ The utmost it can do toward investing another branch of the government with tax powers, is to authorize a board or other official body to promulgate administrative rules and regulations and to organize assessment and collection machinery.

APPLICATION OF CONSTITUTIONAL LIMITATIONS TO TAX STATUTES

Judicial determination of the constitutionality of tax statutes is partly a procedure of strictly syllogistic reasoning, partly an application of authoritarian rules and judicial prejudice. Logical deduction governs the application of a construed constitutional rule to a construed tax statute. The constitutional rule is the first premise of a syllogism. Second premise is the statute in issue. Given these two elements, the conclusion of validity or invalidity is the product of mechanical logic.

But before the courts can apply this routine reasoning, they must construe the meaning of the constitutional limitation which the taxpayer insists is a bar to the levy of the tax being contested. Next they must construe the meaning of the tax statute. Logic is no guide when the issue is one of construction. Rather, the two determinants are the legalistic principle of *stare decisis*—the acceptance of prior judgments on the same point—and the arbitrary personal convictions of the individual judges who sit on the issue.

As new judges with new personal convictions enter the federal and state courts, or as current incumbents change their convictions, the constructions of constitutional phrases and tax statutes undergo transformation. Outright reversals of the opinions of earlier courts are rare phenomena. But frequently only lip service is paid to the principle of *stare decisis*. Judicial acumen can always find a basis for

⁵ *Hampton and Co v U S*, 276 U S (1928) 394, *Panama Refining Co v Ryan*, 293 U S (1935) 388. These two cases apply to the federal government, but the same rule also holds for state governments.

the existence of which gives rise to tax liability—or, in the phrase currently used by the courts, which “generates” the tax. Thus “male persons over the age of 21” may be the subject of a poll tax. A death tax may be construed to have as its subject either the “act” or the “privilege” of transferring property by bequest, inheritance, or otherwise at the death of the owner. “Income” or “the franchise or privilege of doing business within the state as a corporation” may be construed as the subject of a state corporation income tax—with markedly different constitutional results according to the “subject” ascribed to the tax.

The “measure” of a tax is the unit to which the rate of the tax is applied. For a poll tax the measure would be “per person.” For a property tax it would be the value of the taxable property stated in units of \$100 or \$1,000. Measure of a motor vehicle license tax might be the horsepower of the taxed car, or its value, or the mileage operated, or the width of the tires. A possible measure for a business license tax is the population of the city wherein the business is located. Capital stock or assets employed in the taxing state, or the income earned within the taxing state, can be the measure of a state privilege tax on foreign corporations.⁸

Having established the fiction of a distinction between “subject” and “measure” in taxation, the Supreme Court was for a while inclined to hold that if the subject of a tax was within federal constitutional limitations, the measure need not be in harmony with these limitations. Since measure determines the economic character of a tax, this liberal doctrine promised to free federal and state taxation from most of the limiting constructions evolved by earlier courts.

319, the United States Supreme Court said “The power of taxation, however vast in its character and searching in its extent, is necessarily limited to subjects within the jurisdiction of the state. These subjects are persons, property, and business. Whatever form taxation may assume, whether as duties, imports, excises or licenses, it must relate to one or another of these subjects. It is not possible to conceive of any other.” This generalization has been contradicted by later courts, which have repeatedly recognized specific acts, activities, or privileges as proper subjects for taxes.

⁸ In economic discussion, two other terms, “base” and “object” are used, which overlap and combine the legal concepts of “subject” and “measure.” The “base” or “object” of a tax is the economic element which gives immediate rise to tax liability. Thus property is the “base” or “object” of a property tax, corporation income or corporation capital stock of a corporation tax, estates or inheritances of a death tax, sales or sales receipts of a sales tax.

But in 1910, in three corporation tax cases decided in close succession,⁹ the Supreme Court wavered on its earlier liberal position. In determining whether a state tax conformed with the limitations of the federal Constitution, the Court indicated that the measure would have to be taken into consideration. For the decade following, the Court tacked about in uncertainty, threw much of the body of tax law into extreme confusion.

During the 1920's the Supreme Court seemed to be evolving a new doctrine—the measure of a state or local tax as well as its subject must conform to all the limitations of the federal Constitution. Sometimes the Court expressed this principle by declaring that both the substance and the form of state and local taxes must be in harmony with federal constitutional limitations. The rule was applied with uttermost severity. No distinction was drawn between tax laws that discriminated against nontaxable elements and uniform taxes that incidentally applied to such elements.

On two points, however, the Supreme Court refused to make consistent application of its measure-conformity rule. Federal and state death taxes were upheld even though their measures included the value of tax-exempt bonds owned by the decedent.¹⁰ Furthermore, if a special tax was specifically stated to be “in lieu” of property taxes, and if the burden thereby imposed was no greater than the burden of the alternative property tax, the Court was likewise willing to overlook “nontaxable” elements.¹¹

Again in the 1930's the Supreme Court validated some taxes where the measure of a tax included but did not discriminate against “nontaxable” elements.¹² But decisions in conflict with this liberal principle were later handed down,¹³ and the issue hangs in confusion.

⁹ *Western Union Telegraph Co. v. Kansas*, 216 U. S. (1910) 1, *Pullman Co. v. Kansas*, 216 U. S. (1910) 56; *Ludwig v. Western Union Telegraph Co.*, 216 U. S. (1910) 146.

¹⁰ On the authority of *Plummer v. Coler*, 178 U. S. (1900) 115, decided before the subject-measure doctrine was established, but nevertheless cited afterwards as ruling

¹¹ *Cudahy Packing Co. v. Minnesota*, 246 U. S. (1918) 450, and later railroad tax cases

¹² *Educational Films Corporation v. Ward*, 282 U. S. (1931) 379; *Pacific Co. v. Johnson*, 285 U. S. (1932) 480; *Detroit International Bridge Co. v. Corporation Tax Appeal Board of Michigan*, 287 U. S. (1932) 295; *N. Y. ex rel Northern Finance Corp. v. Lynch*, 290 U. S. (1933) 601

¹³ *Schuykill Trust Co. v. Pa.*, 296 U. S. (1935) 113, *Stewart Dry Goods Co. v. Lewis*, 294 U. S. (1935) 550.

CONSTITUTIONAL LAW OF FEDERAL TAXATION

Under the Constitution, the federal government enjoys only those tax powers designated in the clauses of that document. These designated tax powers, however, are very broad, for in Art. I, Sec 8, Congress is given power "to lay and collect taxes, duties, imposts, and excises"—a selection of terms covering practically every sort of exaction that could go under the popular idea of "taxation."

Five specific limitations circumscribe this generous designation of tax powers: (1) the purpose of any federal tax must be "to pay the debts and provide for the common defense and general welfare of the United States"; (2) no tax or duty may be laid on articles exported from any state; (3) except for taxes on income, direct taxes must be apportioned among the states according to population; (4) indirect taxes must be uniform; and (5) the provision of the Fifth Amendment that no person "shall be deprived of life, liberty or property without due process of law" is sometimes construed as a limitation on federal tax powers. Furthermore, from the general constitutional principle of the mutual independence of the federal and state governments, the rule that the federal government may not tax the property, agencies, or instrumentalities of a state government, has been developed.

"General welfare" limitation

The vague qualification that federal taxes should "provide for the . . . general welfare of the United States" could have been construed to mean anything or nothing. Actually it has been applied to but two issues in federal taxation—to earmarked taxes, and to regulatory taxes.

When the revenue from a federal tax goes into the general Treasury fund, the Court will pursue no inquiry into the general character of federal expenditures. But if the receipts of a particular tax are earmarked to a particular function, activity, or expenditure, the Court may then enquire whether that function is truly "for the general welfare." And, should the Court decide in the negative, as it did in the case of the crop reduction payments under the AAA program,

any tax earmarked to that function—in this case the processing taxes—must be declared invalid.¹⁴ Sufficient general welfare inheres in social security payments, however, to support a payroll tax inferentially dedicated to such payments.¹⁵

A levy primarily to discourage or regulate some private activity and productive of no substantial revenue is deemed not levied “for the general welfare.” Should the regulation involved be authorized elsewhere in the Constitution, the tax may be sustained as an exercise of this other power.¹⁶ Where no other power can be adduced in support of the tax, it must fail.¹⁷ But the Court generally takes a very liberal attitude in construing regulatory taxes as revenue rather than control measures.¹⁸

Prohibition against export taxes

The constitutional provision¹⁹ forbidding Congress to levy an export duty is clear and precise. Complicating its application, however, is the difficulty of determining which taxes are export duties and which are not. A federal tax specifically levied on the business of exporting²⁰ or on commodities exported or made or held for export²¹ would come under the prohibition. But the federal courts have further held that a tax which bears “directly and closely” on the “process of exporting” is in substance an export duty.²² Under this construction, a tax on the bills of lading of exported articles,²³ a tax

¹⁴ *U. S. v. Butler*, 297 U. S. (1936) 1.

¹⁵ *Steward Machine Co. v. Davis*, 300 U. S. (1937) 652.

¹⁶ Thus a prohibitory state bank note tax can be sustained as an exercise of the federal government's currency powers—*Veazie Bank v. Fenno*, 8 Wall. (1869) 533; and a protective tariff as an exercise of the federal government's power to regulate foreign commerce—*Hampton & Co. v. U. S.*, 276 U. S. (1928) 394, and *Board of Trustees of University of Illinois v. U. S.*, 289 U. S. (1933) 48.

¹⁷ *Hammer v. Dagenhart*, 247 U. S. (1918) 251; *Lipke v. Lederer*, 259 U. S. (1922) 557, *Hill v. Wallace*, 259 U. S. (1922) 44, *Child Labor Tax Case*, 259 U. S. (1922) 20; *U. S. v. Constantine*, 296 U. S. (1935) 287; *Carter v. Carter Coal Co.*, 298 U. S. (1936) 238. Contradictory earlier cases, probably overruled by the line of decisions above, are *In re Kollock*, 165 U. S. (1897) 526, and *McCray v. U. S.*, 195 U. S. (1904) 27.

¹⁸ See *U. S. v. Miller*, 307 U. S. (1939) 174, holding the prohibitive firearms tax to be a revenue measure.

¹⁹ Art. I, sec. 9, par. 5.

²⁰ *Brown v. Maryland*, 12 Wheat. (1827) 419.

²¹ *Turpin v. Burgess*, 117 U. S. (1886) 504.

²² *Thames and Mersey Marine Insurance Co. v. U. S.*, 237 U. S. (1915) 19, 25.

²³ *Fairbank v. U. S.*, 181 U. S. (1901) 283.

on marine insurance policies covering exported articles,²⁴ and an excise tax on sporting goods sold to foreign customers,²⁵ have all been held unconstitutional. An income tax applying to net income derived from an export business does not come under the prohibition.²⁶

Limitation on levy of direct taxes

According to the Constitution, "no capitation, or other direct, tax shall be laid, unless it shall be apportioned among the several states which shall be included within this union according to their respective numbers."²⁷ This provision clearly applies to the levy of a poll tax or a property tax by the federal government. On the basis of the population count, were the federal government to impose a \$100,000,000 real estate tax, approximately \$10,000,000 would have to be apportioned to New York, approximately \$2,000,000 to Alabama. New York, which has a high per capita average for property values, need impose only one-third mill levy to collect its quota. Alabama, poorer in property values per capita, would have to impose a two-and-a-half mill levy. The unfairness of such distribution of a federal tax is patent. From a practical point of view, then, the clause outlaws a federal property tax.

So long as a definite poll or property tax is not involved, the federal courts have been inclined to construe the term "direct tax" narrowly. The Supreme Court has said:

While taxes levied upon or collected from persons because of their general ownership of property may be taken to be direct, this court has consistently held, almost from the foundation of the government, that a tax imposed upon a particular use of property or the exercise of a single power over property incidental to ownership, is an excise which need not be apportioned.²⁸

In 1895, however, the Court decided that since in effect a federal income tax is a tax on the property producing the income, it con-

²⁴ *Thames and Mersey Marine Insurance Co. v. U. S.*, 237 U. S. (1915) 19

²⁵ *Spaulding and Brothers v. Edwards*, 262 U. S. (1923) 66.

²⁶ *Peck and Co. v. Lowe*, 247 U. S. (1918) 165

²⁷ Art. I, sec. 2, and sec. 9, par. 4

²⁸ *Bromley v. McCaughn*, 280 U. S. (1929) 124.

stitutes a direct tax. On this argument, the 1894 federal income tax was held unconstitutional because it was not apportioned among the states according to population.²⁹ With the ratification of the Sixteenth Amendment in 1913, eliminating the necessity of apportionment in the case of "taxes on incomes, from whatever sources derived," this limitation on the levy of federal income taxes was removed. Subsequently, however, it was decided that stock dividends were not "income," and hence did not come under the Sixteenth Amendment.³⁰

Limitation on levy of indirect taxes

The constitutional provision that "all duties, imposts and excises shall be uniform throughout the United States"³¹ has been specifically stated to require geographic uniformity only.³² What is more, the requirement is limited to geographic uniformity in law as contrasted to geographic uniformity in effect. A federal tax may be levied on a subject, such as tobacco manufacturing, which exists only in certain states.³³ And exemptions and rate differences may be incorporated in a federal tax without bringing it under this limitation.³⁴

"State instrumentalities" limitation

Nowhere does the federal Constitution specifically forbid the federal government to tax state functions or state instrumentalities. Judicial implication³⁵ created this prohibition as a corollary to the corresponding rule, also established by judicial construction, that the states could not tax the functions or instrumentalities of the federal government.³⁶ According to long-established interpretation of the courts, a federal tax could not be levied upon the compensation of

²⁹ *Pollock v. Farmers Loan and Trust Co.*, 157 U. S. (1895) 429, 158 U. S. (1895) 601

³⁰ *Eisner v. Macomber*, 252 U. S. (1920) 189. The tendency is to limit this restriction. A dividend of preferred stock to a common stock holder is taxable—*Helvering v. Gowran*, 301 U. S. (1937) 676.

³¹ Art. I, sec. 8, par. 1.

³² *Bromley v. McCaughn*, 280 U. S. (1929) 124.

³³ *Head Money Cases*, 112 U. S. (1884) 580.

³⁴ *Knowlton v. Moore*, 178 U. S. (1900) 41.

³⁵ *Collector v. Day*, 11 Wall. (1871) 113; *Pollock v. Farmers Loan & Trust Co.*, 157 U. S. (1895) 429, 158 U. S. (1895) 601.

³⁶ See p. 219 of this volume.

state and local officers and employees engaged in the exercise of essential government functions,³⁷ or upon state and local bonds, or the interest thereon.³⁸ Sales to or by a state or local government in connection with any essential governmental function were also protected from federal taxation.³⁹ But all salaries, payments, and receipts were subject to federal taxation where a state or local government acted in a so-called "proprietary" capacity, or where it incidentally supervised or regulated some private activity.⁴⁰

Recently the Supreme Court has reversed itself upon the constitutionality of the application of the federal income tax to state and local salaries generally. In 1938, the Court upheld federal taxation of salaries paid by the Port of New York Authority, not on the ground that the Authority was a proprietary agency, but on the position that the federal tax was nondiscriminatory.⁴¹ A year later the Court faced the issue squarely, overruled *Collector v. Day*, and extended the federal income tax to all state and local salaries.⁴² Still undecided is the issue whether the federal income tax can be extended to the interest on state and local bonds, but by implication such extension should now be warranted. Indeed, the *Graves v. O'Keefe* decision lays the foundation for general elimination of the "state instrumentalities" limitation except as a guard against discriminatory taxation directed against the independent sovereignty of the states.

³⁷ See cases cited in T. M. Cooley, "The Law of Taxation" (fourth edition, Callaghan and Co., Chicago, 1924), Vol. I, pp. 257-259, a recent clear-cut case on the issue is *Brush v. Commissioner of Internal Revenue*, 300 U. S. (1937) 352.

³⁸ *Pollock v. Farmers Loan & Trust Co.*, *cit. supra*. During the period of liberal interpretation of the subject-measure doctrine, the Supreme Court held that inclusion of interest on state bonds in the measure of a federal tax was valid if the subject was constitutionally proper—*Flint v. Stone Tracy Co.*, 220 U. S. (1911) 107. Seventeen years later a more conservative court took a contrary stand on this issue—*National Life Insurance Co. v. U. S.*, 277 U. S. (1928) 508. The Sixteenth Amendment gives Congress power to tax incomes "from whatever source derived." With no particular warrant for the view, this phraseology was long believed not to cover income from a state instrumentality. A contrary opinion was expressed in President Roosevelt's recommendation in April 1938 that this class of income be brought under the federal income tax.

³⁹ *Indian Motorcycle Co. v. U. S.*, 283 U. S. (1931) 570.

⁴⁰ *South Carolina v. U. S.*, 199 U. S. (1905) 437; *Metcalf and Eddy v. Mitchell*, 269 U. S. (1926) 514; *Burnett v. A. T. Geigine Trust*, 288 U. S. (1933) 508; *Ohio v. Helvering*, 292 U. S. (1934) 360; *Helvering v. Powers*, 293 U. S. (1934) 214.

⁴¹ *Helvering v. Gerhardt*, 304 U. S. (1938) 405.

⁴² *Graves v. O'Keefe*, 306 U. S. (1939) 466.

“Due process of law” limitation

So far, the federal courts have made little use of the “due process of law” clause in the Fifth Amendment as a limitation on federal tax powers. This clause stands as protection against a tax classification or discrimination so palpably arbitrary and unreasonable as to seem a confiscation of property rather than an exercise of the tax power. Retroactive application of a tax would be forbidden under this clause when at the time of the transaction which occasioned the tax, the taxpayer could not have understood or foreseen the nature of the tax burden imposed.⁴³

⁴³ *Nichols v. Coolidge*, 274 U. S. (1927) 531, *Blodgett v. Holden*, 275 U. S. (1927) 142

CHAPTER IX

Constitutional Aspects of Taxation *(Concluded)*

FEDERAL CONSTITUTIONAL LIMITATIONS ON STATE AND LOCAL TAX POWERS

UNDER our federal government, since the states are primary sovereign bodies, they possess inherently full tax powers. The Constitution neither designates nor specifies the tax powers they may exercise. Instead, it assumes that they enjoy full taxing power, and establishes certain restrictions on this power.

In all, the federal Constitution imposes nine limitations on state and local tax powers. Two of these are specifically stated as restrictions on the taxing power: (1) the states may not levy import or export duties; and (2) the states may not levy tonnage taxes without the consent of Congress. Five are general restrictions on state powers and apply only incidentally to tax powers: (3) federal treaties are a part of the supreme law of the land; (4) the states may not pass laws impairing the obligation of contract; (5) the citizens of each state are entitled to all the privileges and immunities of citizens in the several states; (6) no state shall deprive any person of life, liberty, or property without due process of law; and (7) no state shall deny to any person within its jurisdiction the equal protection of the laws. The last two restrictions—(8) the states may not tax property or instrumentalities of the federal government; and (9) the states may not tax interstate commerce—are not to be found in any specific wording of the Constitution, but are the offspring of judicial implication.

Relatively few cases have turned upon the first five of these limitations. But the last four have given rise to a flood of litigation in the course of which, to the extreme confusion of principles, the courts have shifted their position several times.

Prohibition against export and tonnage taxes

In all respects, the constitutional¹ prohibition against the levy of export taxes by the states corresponds with the similar prohibition against the federal levy of export taxes.² Neither directly nor indirectly may the states tax either the business of exporting or exported commodities. If some of the income of an exporting concern is derived from intrastate operations, however, a general income tax may apply to its net income.

A tonnage duty is a tax upon vessels according to their size or capacity, for the privilege of entering or leaving a port or navigating the waters of a state. A state tax of this character is strictly forbidden by the federal Constitution,³ but there is no limitation on the levy by states of tonnage fees, property taxes, or other taxes on vessels.

Supremacy of treaties over state tax powers

Unless the states are limited by their own constitutions, their tax laws may discriminate between American citizens and nationals of other countries. Actually, however, they have effected such discrimination only in death taxes. But, should the federal government enter into a treaty with another country providing for reciprocal nondiscrimination as to taxation or property rights, that treaty would override any provisions of state death taxes to the contrary.⁴

Prohibition against impairment of the obligation of contracts

State tax powers are affected in two ways by the provision of the Constitution that no state shall pass any law impairing the obligation of contracts.⁵ Having once issued a tax-exempt bond, a state may not subsequently attempt to tax that bond under a property tax or tax the interest on the bond under an income tax. The orig-

¹ Art. I, sec. 10.

² See p. 206 of this volume.

³ Art. I, sec. 10

⁴ *Mager v. Grima*, 8 How. (1850) 490 If the treaty is limited to the subject of discrimination in property taxes, it does not apply to death taxes since these are not property taxes: *Peterson v. Iowa*, 245 U S (1917) 170.

⁵ Art. I, sec. 10

inal issue with its exemption privilege constitutes a contract which may not be abrogated by legislative action⁶ Similar protection is accorded to any other exemption from state or local taxation of a contractual character. Furthermore, if a local government floats a bond issue under a statute requiring the levy of a tax sufficient to cover the debt service, that tax levy may not be repealed subsequently, and, so long as the bond issue is outstanding, the legislature may not eliminate the requirement of the tax levy.⁷

Prohibition against discrimination against citizens of other states

According to the Constitution, the citizens of each state shall be entitled to all the privileges and immunities of citizens in the several states.⁸ States are thereby prevented from discriminating in their tax laws against citizens of other states, whether resident or nonresident. Peddlers from other states may not be taxed more heavily than resident merchants merely because of nonresidency,⁹ nor may the property of nonresidents be valued at a rate higher than that of residents,¹⁰ nor may a special death tax rate place a heavier tax burden on the estates of nonresident decedents than on the estates of resident decedents.¹¹ Corporations, lacking "citizenship," are not protected by this provision; the states are free to levy different and heavier taxes on foreign corporations than they levy on domestic¹² corporations.¹³

⁶ *Macallan Co v Massachusetts*, 279 U S (1929) 620, cf *Pacific Co, Ltd. v Johnson*, 285 U S. (1932) 480

⁷ *Von Hoffman v City of Quincy*, 4 Wall (1866) 535.

⁸ Art 4, sec. 2.

⁹ *Ward v. Maryland*, 12 Wall (1870) 418.

¹⁰ *Beeson v Johns*, 124 U. S (1888) 56

¹¹ *Smith v Loughman*, 245 N Y. (1927) 486, writ of certiorari refused by the United States Supreme Court, *Loughman v. Smith*, 275 U S (1927) 560

¹² A "domestic" corporation is, from the viewpoint of a taxing state, a corporation organized in that state. A "foreign" corporation is, from the viewpoint of a taxing state, a corporation organized in any other state of the United States. The term "alien corporation," used in later chapters of this volume, is reserved for corporations organized in countries other than the United States.

¹³ But see p 219 of this volume with respect to recent cases on the "equal protection of the laws" limitation as applied to the taxation of foreign corporations.

"Due process of law" limitation

One clause of the Fourteenth Amendment provides that no state shall deprive any person of his life, liberty, or property "without due process of law." In its application to taxation, many lawyers are inclined to regard this broad language as a blanket injunction against excessive exercise of state tax powers. As Judge Cooley said, "In tax cases, especially those carried to the Supreme Court of the United States, it is customary, it seems, to add to other constitutional objections, for good measure, the contention that the tax law violates the due process of law provision."¹⁴ None the less, this "due process of law" clause has three specific applications to state tax statutes: (1) it constitutes an injunction against the levy of a tax beyond the territorial jurisdiction of the state or local taxing government; (2) it may be interposed to check extreme or confiscatory state or local taxes; (3) it prohibits a state from utilizing any forms of assessment or review which are essentially arbitrary, unjust, or unfair, or which deny the taxpayer a fair opportunity to assert his substantive rights before a proper judicial tribunal.

An injunction prohibiting a taxing government from levying a tax beyond its territorial jurisdiction assumes that the subject matter of a tax always has a determinable geographical location. But taxes are levied on all sorts of intangible elements—on acts, on privileges, on legal rights—having no physical existence, much less location. To meet this difficulty, the courts have created the legal fiction of *situs*—namely, legal location. The *situs* of the subject matter of any tax is wherever a court of competent jurisdiction says it is. And since physical laws are no bar to legal paradoxes, a taxable item may have more than one *situs*, may be legally situated in more than one tax jurisdiction, and hence may be subject to more than one tax.

A person has a taxable *situs* at his domicile. Income may have a double *situs*—in the state where it is earned or accrues,¹⁵ and in the state of recipient's domicile.¹⁶ An act or activity has a taxable

¹⁴ T. M. Cooley, *The Law of Taxation* (fourth edition, Callaghan and Co., Chicago, 1924), Vol. I, p. 331.

¹⁵ *Shaffer v. Carter*, 252 U. S. (1920) 37; *Whitney v. Graves*, 299 U. S. (1937) 366.

¹⁶ *Maguire v. Trefry*, 253 U. S. (1920) 12; *Lawrence v. State Tax Commission of Missis-*

situs wherever any essential element is performed.¹⁷ A legal privilege is taxable only by the state which grants it.¹⁸ A corporation's capital stock has a taxable *situs* in the state wherein it is organized¹⁹ as well as in the state of the share-owner's domicile, and so much of the capital stock as is employed in business in other states has an additional taxable *situs* in such states.²⁰

During the nineteenth century, the courts were inclined to ascribe taxable *situs* to any state or district which extended protection to, exercised control over, or could show some interest in the item taxed. Instances of multiple *situs* were common, but the prevailing localization of property interests and the states' simple tax systems made multiple taxation a rare phenomenon. Outside of tax circles, the problem attracted little interest. But as absentee ownership of property and absentee conduct of business increased, as corporate development introduced new complexities of property interests, and as the states extended the scope of their taxes, instances of burdensome multiple taxation became numerous. Protest grew widespread and shrill, and the courts turned ear to it. The turning point was the case of *Union Refrigerator Transit Co. v. Kentucky*,²¹ wherein the Supreme Court discarded the old fiction of *mobilia sequuntur personam*, and gave one *situs*—the state wherein it was located—to tangible personal property permanently used in business. In casual and unsystematic fashion, the Supreme Court during the next thirty years outlawed many forms of double taxation of property interest. During the 1920's and 1930's, in particular, judicial construction swept the field of death taxes clear of all double taxation.

On no occasion, however, did the Court hold that the Fourteenth Amendment implicitly prohibited double *situs* and hence double

Mississippi, 286 U. S. (1932) 276. By a recent decision, even income derived from real property in another state may be taxed by the state of the recipient's domicile—*Cohn v. Graves*, 300 U. S. (1937) 308.

¹⁷ *American Manufacturing Co. v. St. Louis*, 250 U. S. (1919) 459, *Haich v. Reardon*, 204 U. S. (1907) 152.

¹⁸ *Frick v. Pennsylvania*, 268 U. S. (1925) 473.

¹⁹ *Kansas City, M. and B. Railroad Co. v. Stiles*, 242 U. S. (1916) 111, *Schuylkill Trust Co. v. Pennsylvania*, 302 U. S. (1938) 506.

²⁰ *Cudahy Packing Co. v. Hinkle*, 278 U. S. (1929) 460.

²¹ 199 U. S. (1905) 194.

taxation; in each instance the Court itself construed the existence or nonexistence of more than one taxable *situs*. Thus the door was held open for the Court to reinstate double taxation if ever its views changed without any fundamental reversal of basic principles. Such a change in the viewpoint of the Court has recently occurred. A majority now hold the view that where two or more states exercise substantial control over an element of property, income, or business, including the owner of the property or business, and the recipients of the income, all the states involved have a taxing power over the element in question.²² Present status of tax *situs* for property interests is indicated in Table 14.

TABLE 14
TAX *SITUS* FOR PROPERTY INTERESTS

| Property Interest | Domicile of Owner or Creditor | Domicile of Obligor or Debtor | Location of Property | Special Business Use Location |
|--------------------------|-------------------------------------|-------------------------------------|----------------------------|--|
| Real property interests. | | | X | |
| Tangible personalty | | | | |
| Permanent location . . . | | | X | |
| Temporary location | X | | X | |
| Indeterminate location | X | | | |
| Intangible personalty | | | | |
| Money . . . | X | | X | X |
| Bank deposits | X | | | X |
| Open book accounts | X | | | X |
| Negotiable instruments | X | | | X |
| Corporation shares | X | X ¹ | | X |
| Corporation bonds | X | X ² | | X |
| Mortgages | X | | X | |
| Trust corpus | X ³ | Trustee | X | |

¹ Eliminated for death tax purposes by *Farmers Loan and Trust Co. v. Minnesota*, 280 U. S. (1930) 204, confirmed for other purposes by *Scrushell Trust Co. v. Pennsylvania*, 302 U. S. (1938) 506.

² Eliminated for death tax purposes by *First National Bank v. Maine*, 284 U. S. (1932) 312.

³ Domicile of beneficiary eliminated by *Safe Deposit and Trust Co. v. Virginia*, 280 U. S. (1929) 83, domicile of trustor of revocable trust established by *Curry v. McCaless*, 307 U. S. (1939) 357, and *Graves v. Elliot*, 307 U. S. (1939) 383.

²² *Cohn v. Graves*, 300 U. S. (1937) 308, *Guaranty Trust Co. v. Virginia*, 305 U. S. (1938) 19, *Curry v. McCaless*, 307 U. S. (1939) 357, *Graves v. Elliot*, 307 U. S. (1939) 383, *Stewart v. Pennsylvania*, 312 U. S. (1941) 649.

Further issues of territorial jurisdiction and of the application of the "due process of law" clause in the Fourteenth Amendment surround the question of when a foreign corporation is so "doing business" in a state as to be subject to its tax laws. Although the cases on this issue are confusing,²³ some general rules have been established. Isolated acts performed by a corporation within a state do not constitute such "doing business" as to confer taxing jurisdiction upon the state. Incidental acts unconnected with the main purpose for which the corporation was organized likewise fail to confer taxing jurisdiction. Furthermore, unless a foreign corporation is organized and active as a holding company, mere ownership of property does not bring it within the jurisdiction of the taxing state.

"Due process of law" is rarely invoked in defense against *confiscatory* state or local taxes. As the Supreme Court recently stated, "When the power to tax exists, the extent of the burden is a matter for the discretion of the lawmakers . . . even if the tax should destroy a business, it would not be made invalid or require compensation upon that ground alone."²⁴ One of the rare instances where the Supreme Court condemns a state or local tax as "confiscatory" occurs when a new tax, embodying some element of discrimination, applies to a binding commitment made before the new tax was imposed, and when it could not have been anticipated. When a special tax peculiarly heavy upon foreign corporations was levied after a "foreign" railroad had made heavy investments in a state, the Court held the tax "confiscatory" and outlawed by the "due process" clause.²⁵ Similarly, death taxes cannot be applied retroactively to dispositions of property tax-free when made.²⁶ Wherever possible, however, the courts try to avoid construing a tax as retroactive.²⁷

²³ See *Report of Committee on Uniform Act Defining "Doing Business" by Foreign Corporations* (National Conference of Commissioners on Uniform State Laws, Washington, 1930).

²⁴ *Fox v. Standard Oil Co. of N. J.*, 292 U. S. (1935) 40.

²⁵ *Southern Railway Co. v. Greene*, 216 U. S. (1910) 400, see also *Hanover Fire Insurance Co. v. Carr*, 272 U. S. (1926) 494, and *Great Northern Railway v. Weeks*, 299 U. S. (1936) 135.

²⁶ *Nichols v. Coolidge*, 274 U. S. (1927) 531; *Blodgett v. Holden*, 275 U. S. (1927) 142, *Untermeyer v. Anderson*, 276 U. S. (1928) 440, *Coolidge v. Long*, 282 U. S. (1931) 582. But the issue has recently been confused by *Binney v. Long*, 299 U. S. (1936) 280.

²⁷ *Third National Bank v. White*, 287 U. S. (1932) 577.

An exceptional recent application of the "due process" clause was the invalidation of a Louisiana license tax on the privilege of selling advertising space by newspapers with circulations over 20,000 on the ground that it abridged freedom of speech.²⁸

For all taxes involving a valuation to determine the tax basis—property taxes, income taxes where an administrative body assesses the taxable income, and corporate excess taxes—the procedural protection of the "due process of law" limitation is important. There must be a formal act of assessment consisting of a description of the subject matter of the assessment, its inclusion in the tax list, and the determination of its value; furthermore, the assessment must be made a matter of record to inform the taxpayer of both the fact and the amount of his assessment.²⁹ Finally, the taxpayer must be notified of the assessment, and he must have an opportunity to appear before some agency of review and present his case against the assessment.³⁰

"Equal protection of the laws" limitation

In the same sentence of the Fourteenth Amendment which includes the "due process of law" limitation is to be found the provision that no state shall "deny to any person within its jurisdiction the equal protection of the laws." This clause forbids arbitrary or hostile discrimination based on no reasonable distinction. The federal courts are generally loath to condemn any state or local tax law as arbitrary or hostile—if reason can possibly be found for a tax classification, it will usually be upheld.³¹ But many inconsistent decisions stand on the books. Discriminations which have been held to invalidate state or local taxes are: a gross receipts tax on taxicabs operated by corporations with no corresponding tax on taxicabs privately operated;³² a provision that a gift made less than six years prior to a donor's death should be presumed conclusively to have

²⁸ *Grosjean v. American Press Co.*, 297 U. S. (1936) 232.

²⁹ *Illinois Central Railroad Co. v. Kentucky*, 218 U. S. (1910) 551.

³⁰ The cases on this point are many. A leading one is *Turner v. Wade*, 254 U. S. (1920) 64.

³¹ See *Bell's Gap Railroad Co. v. Pennsylvania*, 134 U. S. (1890) 232; *Fox v. Standard Oil Co. of N. J.*, 292 U. S. (1935) 40; *Dixie Ohio Express Co. v. State Revenue Commission*, 306 U. S. (1939) 72.

³² *Quaker City Cab Co. v. Pennsylvania*, 277 U. S. (1928) 389.

been made in contemplation of death, and hence subject to a death tax;³³ intentional and systematic overassessment of a parcel of property as compared with surrounding properties;³⁴ impositions on foreign corporations in excess of taxes levied on comparable domestic corporations;³⁵ and chain-store taxes discriminating between intracounty and intercounty chains,³⁶ or levied in the form of a gross income tax.³⁷ Examples of alleged discriminations held not to be objectionable are: a tax on the distributing house of a group of chain stores which does not apply to the depots maintained by large department stores, and a progressive tax on a series of stores owned by one individual, claimed to be aimed directly at chain stores;³⁸ motor vehicle license charges higher on public carriers than on private carriers;³⁹ exemption from an electric power tax of private power plants and power used for irrigation pumping;⁴⁰ taxation of "other moneyed capital" at a lower rate than state bank shares;⁴¹ a tax on residents' deposits in out-of-state banks five times higher than on their deposits in local banks;⁴² and heavier assessment ratios on railroad property than on other property.⁴³

"Federal instrumentalities" limitation⁴⁴

Judicial construction rather than the federal Constitution forbids the state to tax federal agencies or instrumentalities. In the famous case of *McCulloch v. Maryland*, Chief Justice Marshall argued:

³³ *Schlesinger v. Wisconsin*, 270 U. S. (1926) 230

³⁴ *Sioux City Bridge Co. v. Dakota County*, 260 U. S. (1923) 441, *Southern Railway Co. v. Watts*, 260 U. S. (1923) 519, *Cumberland Coal Co. v. Board of Revision*, 284 U. S. (1931) 23

³⁵ *Southern Railway Co. v. Greene*, 216 U. S. (1910) 400; *Airway Corporation v. Day*, 266 U. S. (1924) 71, *Hanover Fire Insurance Co. v. Carr*, 272 U. S. (1926) 505

³⁶ *Louis K. Liggett Co. v. Lee*, 288 U. S. (1933) 517

³⁷ *Stewart Dry Goods Co. v. Lewis*, 294 U. S. (1935) 550

³⁸ *State Board of Tax Comm'rs v. Jackson*, 283 U. S. (1931) 527, *The Great Atlantic and Pacific Tea Co. v. Morisset*, 284 U. S. (1931) 584, *Fox v. Standard Oil Co. of N. J.*, 292 U. S. (1935) 40.

³⁹ *Continental Baking Co. v. Woodring*, 286 U. S. (1932) 352

⁴⁰ *Broad River Power Co. v. Query*, 288 U. S. (1933) 178, *Utah Power and Light Co. v. Pfost*, 286 U. S. (1932) 165.

⁴¹ *Union Bank and Trust Co. v. Phelps*, 288 U. S. (1933) 181

⁴² *Madden v. Kentucky*, 308 U. S. (1939) 525.

⁴³ *Nashville, Chattanooga & St. Louis Ry. v. Browning*, 309 U. S. (1940) 651

⁴⁴ See Robert E. Hutton, "Reciprocal Immunity of Federal and State Instrumentalities,"

in Tax Policy League, *Tax Relations Among Governmental Units* (New York, 1938), pp. 26-44.

That the power to tax involves the power to destroy; that the power to destroy may defeat and render useless the power to create; that there is a plain repugnance, in conferring on one government a power to control the constitutional measures of another, which other, with respect to those very measures, is declared to be the supreme power over that which exercises the control, are propositions not to be denied. . . . The states have no power, by taxation or otherwise, to retard, impede, burden, or in any manner control, the operations of the constitutional laws enacted by Congress to carry into execution the powers vested in the general government.⁴⁵

Marshall's comments of 1819 are absolute and final law for today. Unless Congress specifically authorizes the application, a state or local tax, no matter how reasonable or nondiscriminatory it may be, is invalid to the extent that it applies to federal property, or federal agents, or federal instrumentalities.

But though the doctrine is established beyond all argument, there remains in issue the construction to be placed upon the concept of "federal instrumentalities." For a long while the courts steadily widened this concept, hampering state and local tax powers at an irritating number of points. Recent decisions indicate, however, that the Supreme Court is narrowing its construction of "federal instrumentalities," even to the point of specifically reversing some of its earlier decisions. At the present time, state tax laws do not apply within federal military posts and reservations.⁴⁶ Since the Indians are the wards of the federal government, their properties are free of state taxes.⁴⁷ States may not tax federal bonds,⁴⁸ nor may the interest on such bonds be brought under a state income tax.⁴⁹ States may

⁴⁵ 4 Wheat (1819) 431, 436

⁴⁶ *Van Brocklin v. Tennessee*, 117 U S (1886) 151, *Irwin v. Wright*, 258 U S. (1922) 219, *Standard Oil Co. v. California*, 291 U S (1934) 242.

⁴⁷ *Stearns v. Minnesota*, 179 U S (1900) 223. Until recently, earnings derived from leases on Indian land could not be taxed by the state, but in line with its policy of limiting the federal and state instrumentalities restrictions, the Supreme Court overruled its earlier decisions and made such income taxable—*Helvering v. Mountain Producers Corp.*, 303 U S (1938) 376.

⁴⁸ *Weston v. Charleston*, 2 Pet (1829), 449, *The Banks v. the Mayor*, 7 Wall. (1868) 16, *Missouri ex rel. Missouri Insurance Co. v. Gehner*, 281 U S (1930) 313.

⁴⁹ But under recent liberal interpretations of the subject-measure rule, a corporation franchise tax may include interest on federal bonds in its measure if no purposed discrimination is involved—*Educational Films Corp. of America v. Ward*, 282 U S. (1931) 379; *Pacific Co., Ltd. v. Johnson*, 285 U S (1932) 480.

tax the federal government's contractual payments to outside individuals or organizations.⁵⁰ Prior to 1939, federal salaries could not be subjected to state income taxes, but in that year two Supreme Court decisions⁵¹ and the federal Public Salary Tax Act fully cleared the way for this tax element. National banks are federal instrumentalities and the states may tax them only within the limits prescribed by federal statute.⁵²

In spite of the recent more liberal interpretations of the "federal instrumentalities" limitation, it continues to be an awkward restriction on state and local tax powers, productive of inequitable discriminations and loopholes for evasion. Most economists hold that the prohibition should be against *discriminatory* taxation of federal instrumentalities, not against *all* state and local taxation. And according to most students of constitutional law, a simple federal statute giving consent to nondiscriminatory taxation of federal employees, agencies, and instrumentalities could accomplish such reform. Congress did this very thing in connection with state and local taxation of national banks,⁵³ and the validity of the statute has never been questioned. Possibly such a statute might contain a reciprocal clause—permission to tax federal instrumentalities would be extended to all states that granted the federal government corresponding permission with respect to state instrumentalities. By this expedient the way would be paved for removal of an awkward impediment to uniform federal and state taxation.

Interstate and foreign commerce limitations⁵⁴

State governments are constitutionally forbidden to levy import, export, or tonnage duties.⁵⁵ But state taxation of interstate or for-

⁵⁰ *James v. Dravo Contracting Co.*, 302 U. S. (1937) 134; *Silas Mason Co v Tax Commission*, 302 U. S. (1937) 186.

⁵¹ *Graves v. O'Keefe*, 306 U. S. (1939) 466; *State Tax Commission v. Van Cott*, 306 U. S. (1939) 511

⁵² See pp. 385-386 and p. 520 of this volume.

⁵³ See p. 385 of this volume.

⁵⁴ A recent study on this topic is Maxwell M. Mahany, *Commerce Clause Tax Problems* (Commerce Clearing House, Chicago, 1940)

⁵⁵ Art. I, sec. 10. But note a possible exception, under the Twenty-First Amendment, in the matter of state import taxes on liquor—*State Board of Equalization v. Young's Market Co.*, 299 U. S. (1936) 59.

eign commerce is not otherwise explicitly prohibited. From the doctrine of the division of federal and state powers, however, the federal courts have implied extensive limitations upon state powers to tax foreign and interstate commerce. For a long while judicial construction expanded the scope of these implied limitations, to the serious injury of state and local tax systems. In recent decisions this trend has been reversed, and the severity of many earlier rulings is being relaxed.

As the law now stands, any state or local tax which directly or indirectly effects a discrimination against interstate or foreign commerce as a business⁵⁶ or against goods brought in from another state or country,⁵⁷ is beyond question unconstitutional. Furthermore, there are limitations to the application even of nondiscriminating uniform taxes to interstate business and to property used in interstate commerce. Commodities in interstate commerce not yet arrived at their final destination,⁵⁸ and commodities in foreign commerce unsold by the importer or still in their original packages,⁵⁹ may not be taxed by the states. Once such goods have come "to rest," even temporarily, at any stage in the distributive process, or any time after a sale within the state has been consummated,⁶⁰ they may be taxed.⁶¹ By recent decisions, goods bought by a consumer from a seller in another state, and held or stored for use, are subject to state taxation.⁶²

A state may not tax the gross receipts of an individual or a corporation when a portion of such receipts are derived from interstate

⁵⁶ *Brown v. Maryland*, 12 Wheat. (1827) 419; *Interstate Transit Co. v. Lindsey*, 283 U. S. (1931) 183, *Cooney v. the Mountain States Tel. and Tel. Co.*, 294 U. S. (1935) 384, *Hale v. Bimco*, 306 U. S. (1939) 375

⁵⁷ *Welton v. Missouri*, 91 U. S. (1875) 275. Note that under the Twenty-First Amendment, this restriction does not apply to state liquor taxes—*State Board v. Young's Market Co.*, 299 U. S. (1936) 59

⁵⁸ *Sonneborn Brothers v. Cureton*, 262 U. S. (1923) 506

⁵⁹ *Burke v. Wells*, 208 U. S. (1908) 14

⁶⁰ *Sonneborn Brothers v. Keeling*, 262 U. S. (1923) 506

⁶¹ *Minnesota v. Blassius*, 289 U. S. (1933) 717, *Southern Pacific Co. v. Gallagher*, 306 U. S. (1939) 167

⁶² *Eastern Air Transport Co. v. South Carolina Tax Commission*, 285 U. S. (1932) 147; *Gregg Dyeing Co. v. Query*, 286 U. S. (1932) 472; *Nashville, C. & St. L. Railway v. Wallace*, 288 U. S. (1933) 249, *Edelman v. Boeing Air Transport*, 288 U. S. (1933) 595, *Henneford v. Silas Mason Co.*, 300 U. S. (1937) 577, *Southern Pacific Co. v. Gallagher*, 306 U. S. (1939) 167, *McGoldrick v. Berwind White Mfg. Co.*, 309 U. S. (1940) 33.

sales or other interstate business activities, according to earlier cases.⁶³ The current view is that such gross receipts taxes are permissible when they include provision for allocation so that double taxation of interstate business cannot occur.⁶⁴ Unless net income is derived exclusively from interstate activity, it is held to be too far removed from interstate business activity for a state income tax thereon to constitute a burden on interstate or foreign commerce.⁶⁵ Intrastate business activities of foreign corporations may be taxed on the basis of allocated income or capital stock, but if the corporation does no intrastate business, its interstate business alone may not be the basis for a corporation tax of any kind.⁶⁶ A state tax on foreign corporations, argue the courts, has as its possible subjects only the privilege or the act of doing intrastate business as a corporation. With either of these subjects, a state tax on foreign corporations may not be applied to a corporation doing no intrastate business.

Authorities on constitutional law generally agree that all the vexatious restrictions on state taxation erected through court construction of interstate and foreign commerce limitations could be eliminated by a federal statute. In 1934 the National Association of State Tax Administrators vigorously campaigned for a federal law to authorize nondiscriminatory state taxation of sales, property, and business involved in interstate commerce. A resolution to permit such taxation passed the Senate in this year, but failed in the House.

⁶³ *Crew Levick Co. v. Pennsylvania*, 245 U. S. (1917) 292; *New Jersey Bell Telephone Co. v. State Board of Assessors*, 280 U. S. (1930) 338, *Fisher's Blend Station v. State Tax Commission*, 297 U. S. (1936) 650. But note the exception made when the gross receipts tax is in lieu of a property tax—*Cudahy Packing Co. v. Minnesota*, 246 U. S. (1918) 450, and later railroad tax cases.

⁶⁴ *Adams Manufacturing Co. v. Storen*, 304 U. S. (1938) 307, *Gwin v. Henneford*, 305 U. S. (1939) 434.

⁶⁵ *United States Glue Co. v. Oak Creek*, 247 U. S. (1918) 321.

⁶⁶ *Cheney Brothers v. Massachusetts*, 246 U. S. (1918) 147, *Alpha Portland Cement Co. v. Massachusetts*, 268 U. S. (1925) 203, *Anglo-Chilean Nitrate Sales Corp. v. Alabama*, 288 U. S. (1933) 218. The implication was made in the last-named case that the defect was in the subject of the tax, and that had the subject been satisfactory, under the current liberal construction of the subject-measure rule, the Court would have overlooked the application of the measure of the tax to a business exclusively interstate. Note also, that the current liberal tendency of the Supreme Court is to avoid construing the business of a taxed corporation as interstate commerce or exclusively interstate commerce—*Utah Power and Light Co. v. Pfoft*, 286 U. S. (1932) 165, *Atlantic Lumber Co. v. Commissioner of Corporations and Taxation*, 298 U. S. (1936) 553, *Western Livestock Co. v. Bureau of Revenue*, 303 U. S. (1938) 250; *Coverdale v. Ark.-La Pipe Line Co.*, 303 U. S. (1938) 604.

STATE CONSTITUTIONAL LIMITATIONS ON STATE AND LOCAL TAX POWERS

When state and local governments enact tax laws, they must consider not only federal but state constitutional limitations. A few states impose no constitutional restrictions whatsoever on state or local taxing power, allowing the legislature full discretion in the enactment of tax statutes. Louisiana, at the other extreme, has embodied the entire tax system of the state and local governments in the state constitution. State constitutions occasionally prohibit outright the levy of some particular form of tax; prior to 1930 the Florida constitution prohibited the levy of state income or death taxes. More often, state constitutions merely prescribe or limit the bases or method of levying state and local taxes.

History of state constitutional limitations

In the minds of the earliest state constitution makers, taxation was a minor problem. Only seven of the twenty-two state constitutions adopted between 1776 and 1796 mentioned taxation, and then only to state that tax levies should not be made without the consent of the people or their representatives in the legislature. Of the fifteen state constitutions adopted between 1796 and 1834, only seven mentioned taxation. Popular apprehension of taxation tyranny having disappeared by this time, provision for the "consent" of the people was ignored. Injustice perpetrated by tax discriminations was the new fear, and several constitutions of this period required taxes to be "equal and uniform."

Constitutional limitations on state tax powers multiplied from 1834 on. Prior to the Civil War, constitutional provisions relating to taxation were concerned for the most part with equal and uniform taxes, or specified taxable or exempt classes of property and occupations. After the Civil War, state constitutional limitations on tax powers became more numerous and detailed. Equality and uniformity provisions continued to be enacted and classes of property to be exempted were minutely specified. Some of the new state constitutions placed rate limitations on state property taxes. Southern state

constitutions gave attention to occupation and special license taxes. A few constitutions of this period specifically authorized the levy of state income or death taxes. Some made provision for corporation taxation.

Twentieth-century constitutions and constitutional amendments indicate some reversal of sentiment on the necessity and expediency of constitutional limitations for state and local tax powers. Occasionally a new restrictive provision has been voted. More frequently, previous restrictions have been removed or particular forms of taxes authorized. Many states have modified the "equality and uniformity" provisions of their constitutions in order to levy classified property taxes.⁶⁷

"Equality and uniformity" limitations

Most state constitutions embody some provision for uniform or equal taxes. Several require taxes to be both "equal" and "uniform," or "proportional" and "uniform." Others require only "uniformity." A considerable number of states require "uniformity" only within the classes of persons or property taxed.

Unlike the "equal protection of the laws" limitation of the federal Constitution, the "uniformity" limitations in state constitutions generally apply only to property taxes. In a few states, however, as in Texas, the constitution itself specifically provides that the "uniformity" provision shall apply to other taxes as well as to the property tax. State courts have sometimes held, as in Georgia, that a general "uniformity" provision applies equally to taxes other than property. Or, as in Washington⁶⁸ and Illinois,⁶⁹ they have arrived at the same practical result by construing taxes on income from property as taxes on the property itself, and hence subject to the limitations on property taxation.

Although the federal Constitution's "equal protection of the laws" limitation permits tax discrimination between individuals and corporations, state "uniformity" limitations are construed to prevent

⁶⁷ See pp. 404 ff. of this volume.

⁶⁸ *Culliton v. Chase*, 174 Wash. (1933) 363, 25 P(2) 81.

⁶⁹ *Bachrach v. Nelson*, 349 Ill. (1932) 579, 182 N.E. 909.

such discrimination, at least in property taxation. Furthermore, some state constitutions specifically forbid tax discrimination between corporations and individuals. Constitutions like those of Illinois and Mississippi provide that corporation property shall be subject to the same taxation as that of individuals. Others, as in Alabama and Kentucky, require individuals and private corporations to be taxed at the same rate.

"Equality" and "uniformity" requirements in state property taxation relate to the rate of taxation, to the assessment ratio of the taxed property, to territorial equality, and, in some states, to the inclusion of all property under the tax unless specifically exempted by the constitution. The tax rate must be the same on all property, or on property within a given class. Valuation must be based on the same percentage of the "true" value of the taxed property, at least as to the same class of property. All property must be taxed, it is held in some states, although there is much conflict of opinion because of the variations in wording in different constitutions. The state tax rate must be uniform throughout the state, the county tax rate throughout each county, and the rate of each district must be uniform throughout the district. But requirements of "equality" and "uniformity" do not apply to the method of levying, assessing, or collecting taxes, nor to inequality resulting from the error or misconduct of the tax officials, nor to provisions allowing the deduction of indebtedness, nor to provisions fixing the *situs* of personal property for purposes of taxation. So long as the resulting tax burdens are reasonably uniform, classifications of property for administrative purposes are generally held to be allowable.

CHAPTER X

Shifting and Incidence of Taxes

IT IS COMMON knowledge today that when a state collects a gasoline tax of three or four cents a gallon from motor-fuel distributors, it is not these distributors who bear the burden of the tax. They charge the tax to the service stations, and these in turn pass the tax on to the motorist who buys two, or five, or ten gallons of gasoline. Very likely the gasoline pump will bear a notice which states the net price of gasoline per gallon, the tax to be added, and the total price that the motorist must pay.

We take it for granted that a cigarette tax and a liquor tax are passed on to consumers, though there may be some question as to whether the ultimate price of the taxed items has been increased by exactly the amount of the tax, or by more than the tax, or by less. But what, if any, are the effects on prices of property tax rates, of personal income taxes, of capital stock taxes on corporations, of the federal customs duties, of an inheritance or estate tax? To what extent can these taxes be shifted by the original payers to other elements in the community, thus transferring tax burdens from those who pay the collector to others who have no direct contact whatsoever with the machinery of tax administration? To what extent do these taxes add to the costs of the original payers yet permit no corresponding expansion of gross income through price adjustments, so that the original payers find their net income or profits reduced?

In short, who ultimately bears the burden of the various taxes imposed by the federal, state, and local governments of this country?

This question has challenged the keenest thought of fiscal economists since men began to speculate on problems of taxation. Literature on this subject is more profuse than on any other issue in Public Finance. Although there may be wide confusion in the popular mind on how tax burdens may be shifted and whom they ultimately

burden, the fundamental principles involved have been well worked out in tax literature, and there is substantial agreement on most basic conclusions.

Two new terms—"shifting" and "incidence"—appear throughout this discussion, and require precise definition. *Shifting*¹ a tax connotes the transfer of the burden of a tax by the original payer to someone else. The tax may be added in proportioned fractions to the prices of the goods or services sold by the original payer, and thus be *shifted forward* to consumers. Or the original payer may reduce the prices paid for purchases—the prices of raw materials, the rent of land and buildings, the interest on borrowings, the wages of employees—and so *shift* the tax *backward* to the producers of raw materials, to the landlord, to the creditor, or to the employees. Cases of backward shifting of a tax are rare, and the discussion of this chapter deals primarily with forward shifting.

The term "incidence" is applied to the ultimate resting of a tax upon some individual or class of individuals who are unable to shift it further along. Possibly a tax may be shifted but once from the original taxpayer, in which case the *incidence* of the tax is clearly upon the group who have received the transferred burden. Possibly the process of shifting may proceed through a long chain of economic relationships, with fractions of the tax burden clinging along the chain, until there is no immediate connection between the original taxpayers and those who collectively bear the burden of the tax; in this case the *incidence* of the tax has become diffused.

HISTORICAL SURVEY

No ordered line of historic development may be traced through the welter of writings on the economic effects of taxation. Most of the literature on the subject has been controversial rather than academic. And as the accidents of fiscal legislation modified the

¹ The subject of tax shifting is discussed by some writers under the titles "escape," "evasion," and "avoidance." But since these terms are of more value elsewhere in Public Finance than in the present instance, their use is reserved for a later chapter (see p. 305 of this volume). The student should bear in mind, however, that in many discussions of this subject, both popular and scholarly, "escape," "evasion," and "avoidance" are used as synonyms for "shifting."

issues of controversy, old doctrines have been dropped as irrelevant and new unrelated ones propounded and expounded. Our history of the economic theory of taxation, consequently, is more the record of episodic and often contradictory approaches to the subject, than a progressive development of knowledge.

✓ Doctrines of the English excise controversy

Tax economics first emerged as a popular issue in England during the late seventeenth and early eighteenth centuries. The controversy turned upon a proposal to levy a general excise or tax on the domestic production or sale of all commodities. Several pamphleteers, including no names of importance, wrote to prove that such a tax would burden the producers and dealers who originally paid it. One school of writers, of whom the most noted was William Petty,² argued that producers or dealers would shift the tax to the purchasers of the taxed articles, and that the consumers would bear the burden in proportion to their expenditures for articles of consumption. Another group, headed by Thomas Mun,³ argued that poorer consumers would be reimbursed for this tax burden by obtaining higher wages, and the burden of the tax would thus be shifted a step further to the manufacturers who paid their wages. In turn, by embodying the increased wage burden in the prices of luxury articles, the manufacturers would shift it to rich consumers. A fourth school of writers, of whom the most famous was the philosopher John Locke,⁴ believed that a general excise on commodities would eventually rest as a burden on landlords' rent. Tenant farmers as well as other employers would be compelled to pay higher wages for their labor. At the same time the market for their produce would be narrowed by the tax, since general purchasing power would be reduced. Landlords would have to reduce their tenants' rent, if the latter were to derive even a minimum livelihood from their rented land.

² *A Treatise of Taxes and Contributions* (London, 1662).

³ *England's Treasure by Forraign Trade, or, the Ballance of our Forraign Trade is the Rule of our Treasure* (written 1630; pub London, 1664)

⁴ *Some Considerations of the Consequences of the Lowering of Interest, and Raising the Value of Money* (London, 1691).

Doctrines of the Physiocrats

The group of French writers known as Physiocrats⁵ developed the theory of tax incidence casually stated by Locke into a philosophy of taxation. They based their doctrine on two propositions: (1) wages persist at a minimum-of-subsistence level, hence any tax touching wage-earners would force the payment of higher wages, and shift the tax to their employers; (2) any tax which thus affected industry, commerce, or the professions would tend to drive capital out of these lines by reducing profits, and the reduced supply resulting would lead to increased prices, thus shifting the tax to other elements of the community. Landowners were the only economic class with a "surplus" out of which taxes might be paid.

These "scientific" doctrines of the Physiocrats led to the conclusion that no matter upon whom, or in what form, a tax was levied, its burden ultimately rested upon the rent received by agricultural landlords. Since, said the Physiocrats, the process of shifting a tax levied on wage-earners, manufacturers, merchants, or professional men might cause serious economic disturbances and maladjustments, all tax revenue should be raised by a single tax on agricultural rent—the ultimate source of all tax revenue. Such a tax would involve none of the friction of shifting, and would cause the least economic disturbance.

Doctrines of Adam Smith

Adam Smith devoted a substantial portion of his *Wealth of Nations*⁶ to the problem of the incidence and shifting of taxes. His theories, developed in part from those of the Physiocrats, were broader and less doctrinaire. Briefly summarized, his argument was that taxes on wages, on industrial profit (interpreted as compensation for risk), and on commodities which could be classified as necessities, were always shifted—partly to landowners, partly to rich consumers, and to a small extent to the lenders of capital. Taxes on land or luxuries were not shifted; they remained a burden on landowners or on rich consumers.

⁵ Including Quesnay, Mirabeau, Mercier de la Rivière, Du Pont de Nemours, Baudeau, Le Trosne, and Turgot

⁶ *An Inquiry into the Nature and Causes of the Wealth of Nations* (London, 1776), Book V, Ch. II, Part 2.

Doctrines of David Ricardo

Ricardo's principles of tax incidence⁷ were, in the main, an elaboration of the doctrines of Adam Smith, although they disagreed on some details. The Ricardian doctrine embraced six points: (1) A tax on economic rent is not transferable; it remains on the landlord. (2) A tax on the wages of ordinary labor is transferred to the employer, and is in reality a tax on profits. (3) A tax on profits in general is not transferable; it remains on the capitalist. (4) But a tax on the profits of a particular employment will be transferred to the consumers of its product, since capital will shift out of the burdened industry, its output will decline, and the resulting scarcity will raise prices for the line. (5) Taxes on commodities paid by the producer (including tithes and other land taxes except those on rent) are, like taxes on particular profits, shifted to the consumer. (6) In the case of commodities consumed by the laborers, there is a further shifting to the capitalists by whom these laborers are employed. These principles, enunciated by Ricardo, were the background of the fiscal writings of the English Classical economists.

"Equal-diffusion" theory of tax incidence

While Ricardo's theories ruled the history of English fiscal thought, a doctrine of incidence known as the "equal-diffusion theory" came to the fore on the Continent and in the United States.⁸ Under this doctrine, every tax, however laid and whatever its form, was eventually diffused equally and equitably throughout the economic community through the process of continuous shifting. The practical conclusion of this doctrine was that any tax, no matter how unjust in its original levy, by continued application achieved justice in the distribution of its burden. A legislature could blunder only by levying a new kind of tax.

⁷ *On the Principles of Political Economy and Taxation* (London, 1817), Chs VIII-XVII.

⁸ Prominent expositions of the "equal-diffusion theory" were in France—M. A. Thiers, *De la Propriété* (Paris, 1848); in Germany—M. v. Prittwitz, *Theorie der Steuern und Zölle* (Stuttgart, 1842); in Austria—L. v. Stein, *Lehrbuch der Finanzwissenschaft* (Leipzig, fourth edition, 1878); in the United States—D. A. Wells, "Principles of Taxation," in Lalor's *Cyclopaedia of Political Science*, Vol. III (1884).

Modern developments in incidence theory

Fiscal economists in more recent times have avoided committing themselves to any single generalized theory of tax incidence. Instead, they have devoted themselves to filling gaps in the theories of the older economists, checking and correcting the details and the particular applications of these general theories, and improving their expression. The marginal analysis of price determination as developed by the Austrian School and Alfred Marshall provided a foundation for new theories on the shifting of commodity taxes. With the development of the doctrine of the capitalization of periodic taxes,⁹ a very important omission in the older theories of incidence was filled in. Statistical research has provided inductive verification for many propositions that had been previously only unproved generalizations. Finally, the symbolic technique has permitted a more concise and a more searching analysis of the various problems of tax incidence¹⁰ than was possible for the older economists.

BASIC FACTORS IN TAX SHIFTING

Whether a tax can be substantially shifted depends on (1) the nature of the tax,¹¹ (2) the economic circumstances under which it is

⁹ Particularly by K. H. Rau, *Grundsätze der Finanzwissenschaft* (Heidelberg, 1832) and by A. E. F. Schaffle, *Die Grundsätze der Steuerpolitik und die schwebenden Finanzfragen* (Tübingen, 1880).

¹⁰ See, particularly, F. Y. Edgeworth, "The Pure Theory of Taxation," in his *Papers Relating to Political Economy* (London, 1925), and A. C. Pigou, *A Study in Public Finance* (London, 1928).

¹¹ The question of what types of taxes can be shifted is often begged, and the issue confused, by use of the terms "direct tax" and "indirect tax." These terms were first developed by the Physiocrats—"direct" for nonshifted taxes, "indirect" for shifted levies. Adam Smith used them loosely according to distinctions in assessment methods—"direct" for taxes assessed according to income or property, "indirect" for taxes assessed in proportion to expenditures. Subsequent writers have twisted and turned the words to a confusing variety of meanings. Some authors consider "direct taxes" the periodic taxes on persons or property, and "indirect taxes" the nonrepeated impositions on commodities. Other writers have used the terms to distinguish between taxes on objects as against taxes on events, between taxes on possession as against taxes on consumption, between taxes on production as against taxes on consumption, between taxes on income as against taxes on expenditure. And, as we saw in Chapter VIII (p. 207 of this volume), American law uses the two terms in a special sense divorced from all economic considerations. Such confused and contradictory usage has robbed the terms "direct" and "indirect" of any value they might possibly have had in fiscal economics. In accordance with Professor

levied,¹² and (3) the taxpayers' practices in taking advantage of any possibility of shifting. The relation of the first two factors to the problem of tax shifting constitutes the subject matter of this chapter. As to the third factor, the generalization may be made that rarely do the practices of taxpayers operate to prevent tax shifting where the economic possibility exists.

Two generalizations—they might almost be called canons—on the relation between the nature of a tax and the possibility of shifting it may be stated before proceeding to a consideration of the incidence of the various types of taxes.

1. A tax cannot be shifted when it is purely personal—when, like a general poll tax or an inheritance tax, it has no relation to any business dealings of the taxpayers. This is so because taxes can be shifted only through business relations, through the prices (including wages and rents) charged for goods and services. These price changes, in turn, are determined by changes in the demand or supply of the commodity or service involved. And a personal tax cannot modify supply or demand, since it does not affect any business relationships which can in turn affect demand or supply.

2. A tax upon "economic surplus" cannot be shifted. "Economic surplus" has been defined as "that part of a payment or accretion of purchasing power which is not necessary either to maintain the service of a factor of production, or to its necessary or desirable increase."¹³ Included in this concept are net rent, net profits, and such windfall receipts as capital gains, inheritances, and gambling gains. Net rent and net income do not affect prices or

Bullock's suggestion that these two terms be expelled from tax discussion as *agents provocateurs*, they are not employed in this study

¹² A special case under this heading, emphasized by some writers, occurs where an earmarked tax is spent for a purpose that affects the basis of the tax. Thus the building of motor highways with revenues derived from gasoline taxation increases the demand for gasoline, and affects its price over and above the price effect of the shifting of the tax. Such a situation is rare, and no further analysis is given to it in this volume. For an able discussion of this issue see M. Slade Kendrick, "The Incidence and Effects of Taxation," *American Economic Review*, Vol. XXVII, December 1937, pp. 725-734, and Alfred G. Buehler, "Public Expenditures and the Incidence of Taxes," *American Economic Review*, Vol. XXVIII, December 1938, pp. 674-683.

¹³ Merlin H. Hunter, "The Taxation of Economic Surplus," *Tax Magazine*, May 1935, p. 270

costs, but are determined by them. Inheritances and gambling gains have nothing to do with business procedure. Hence a tax on any of these elements cannot work itself either forward or backward into prices or cost payments.

INCIDENCE OF SPECIAL COMMODITY TAXES

To what extent a tax on a particular commodity may be shifted differs according to whether the commodity is produced under circumstances of business competition or monopoly. Consideration here will be given primarily to the shifting, incidence, and related economic effects of taxes on commodities produced competitively. The circumstances of taxes on commodities produced monopolistically will receive supplementary treatment.

Tax incidence on competitively produced commodities is pre-eminently dependent upon the character of the demand for the taxed commodities and upon the cost factors inherent in their production.

Character of demand as a factor

If a tax proportional to the price of a commodity—or, what is practically equivalent, per unit—is levied on its production or sale, the producers or dealers of that commodity tend initially to add the amount of the tax to the original prices. Since all producers or dealers who handle the commodity must pay the tax, there will be no competitive factor to check this tendency to shift the tax by adding it to the price of the commodity.

Consumption demand, depending on the nature of the commodity in question, may be extremely elastic, moderately elastic, or comparatively inelastic in relation to price. For the so-called “middle-class luxuries” like table delicacies, demand is sharply elastic—that is, purchases of the commodity will vary widely inversely to its price. Were the producers or dealers to follow their initial tendency and add a tax to the original price of such commodities, purchases would be reduced markedly. A tax added to the original price of a commodity for which demand is only moderately elastic would produce a similar though less extreme reduction in demand.

But where demand, as in the case of salt, is very inelastic, it would not be affected by the addition of a tax to the original price.¹⁴

Long-term character of supply as a factor

As we have seen, the addition of a tax to the original price of a particular commodity reduces purchases to the extent that demand for the commodity is elastic. In the long run, the producers must reduce their output in accordance with the decline in purchases. Assuming that the loss of market is distributed proportionately among all producers, the effect of such reduction of output upon the price charged varies with the character of the supply of the commodity—whether it is produced at constant, increasing, or decreasing cost.

If the taxed commodity is produced at constant cost,¹⁵ reduction in output will not affect cost price. Cost price remains the same

¹⁴ The three propositions stated above may be illustrated by the following diagrams.

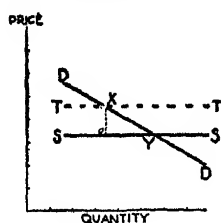


FIGURE I
HIGHLY ELASTIC DEMAND

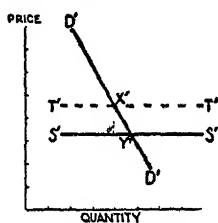


FIGURE II
MODERATELY ELASTIC DEMAND

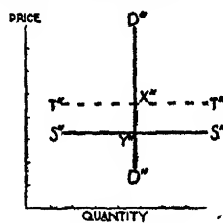


FIGURE III
INELASTIC DEMAND

Demand for the commodity represented in Figure I, indicated by the line DD, is highly elastic—as the price per unit falls, purchases increase rapidly. Demand for the commodity represented in Figure II has considerable elasticity, but not so marked as in the preceding case. In Figure III, demand for the commodity represented is absolutely inelastic—line D''D'' is vertical and no change in unit price can cause purchases of the commodity to increase or decrease in amount.

Lines SS, S'S', and S''S'' represent the original supply prices of the three commodities before the imposition of the tax. The amount of each commodity purchased at these original supply prices is indicated by the points Y, Y', and Y''. Lines TT, T'T', and T''T'' represent the prices charged for the three commodities after the producers or dealers have added an identical tax to the original price of each. The amount of each commodity purchased at the increased price is indicated by the points X, X', and X''.

The horizontal distances OY and O'Y' indicate the reductions of purchases which result in the first two cases from the addition of the tax to the original price. Note that the horizontal distance OY is greatest in Figure I, which represents a commodity with an extremely elastic demand. In Figure III, representing a commodity with an absolutely inelastic demand, there is no horizontal difference whatsoever between X'' and Y''.

¹⁵ That is, the cost of production is constant for all amounts of the commodity within the range of the decreased demand resulting from the addition of the tax to the original price.

whether the output is large or small, and producers or dealers add the tax to this constant cost price. Consumers may purchase smaller amounts, but they pay the original price plus the tax

If the taxed commodity is produced at increasing cost, as are many agricultural products, the consequent reduced supply can be placed on the market at a lower cost price. In the reduction of output, the last, most expensive increments of the supply, which originally determined the price for the whole supply, will be lopped off. But the initial drop in purchases was predicated on the addition of the tax to the initial cost price of the original supply. Actually, the price of the reduced supply (including the tax) will be somewhat lower than the price at the original cost plus the tax. Therefore, the fall in demand will not be as great as was first assumed, nor will the reduction of supply and hence of cost price be so large. In the long run, the imposition of a tax on commodities produced at increasing cost results in a new price equilibrium higher than the original price, but not higher by the full amount of the tax.

When, as with many standardized machine-made goods, the taxed commodity is produced at decreasing cost and large output permits economies of production and distribution, a reduction of output, by preventing these economies, will cause the reduced supply to be placed on the market at a higher cost than the original supply. The new unit cost plus the tax will be higher than the original cost plus the tax which caused the initial reduction of purchases. Purchases will be further reduced, causing further drops in output and still higher unit costs until either a new price equilibrium is reached or the commodity goes off the market. When a tax is imposed on a commodity produced at decreasing cost, the new price equilibrium, if reached, is higher than the original price and by more than the amount of the tax.¹⁶

Special circumstances of demand and supply

Two distinct commodities may be so nearly identical in many of their attributes that, from the point of view of the individual's

¹⁶ The effect of a tax imposed on a commodity having elastic demand under the circumstances of supply at constant cost, at increasing cost, and at decreasing cost, may be illustrated by the following diagrams:

consumption demand and of general consumption demand, they are competitors. Examples of such competing or rival commodities are oleomargarine and butter, and domestic goods which compete with imported goods. So long as the prices of the two commodities are approximately the same, or bear a reasonable relation to quality differences, both commodities will maintain their positions on the market. Should a tax be levied on one of these commodities, and should the producers or sellers seek to add the tax to the price, consumer demand will shift from the taxed to the untaxed commodity.

What effect this shift of purchases will have on the prices of the two competing commodities will depend upon the character of their supply. Where both are produced at constant or at decreasing cost, the taxed commodity will be driven completely off the market unless it succeeds in tapping a specialty demand, since it can never

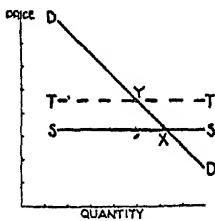


FIGURE I
CONSTANT COST

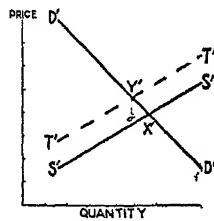


FIGURE II
INCREASING COST

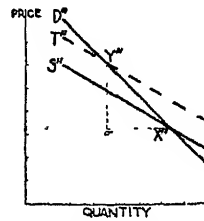


FIGURE III
DECREASING COST

The slanting lines DD , $D'D'$, and $D''D''$ represent elastic demand for a commodity

In Figure I, the supply of the taxed commodity is produced at constant cost (line SS , representing the series of original supply prices for all amounts of the commodity, is horizontal), and purchases and supply equilibrate at price X . The addition of the tax to the series of original supply prices for all amounts (line TT being higher than line SS by the amount of the tax) results in a decrease of purchases equal to OX , but the vertical difference OY between points Y and X is exactly the vertical difference between lines SS and TT —the new price is higher by exactly the amount of the tax.

In Figure II, the supply of the taxed commodity is produced at increasing cost (line $S'S'$, representing the series of original supply prices for all amounts of the commodity, slants upward to the right), and purchases and supply equilibrate at price X' . As in the preceding case, the addition of the tax to the series of original supply prices results in reduced purchases. Because of the slant of the lines $S'S'$ and $T'T'$, the vertical distance $O'Y'$ between points X' and Y' is less than the vertical distance between lines $S'S'$ and $T'T'$ —the new price is higher by less than the amount of the tax.

In Figure III, where line $S''S''$ represents the series of original supply prices of a commodity produced at decreasing cost (the slant of line $S''S''$ is downward to the right), the contrary slant of lines $S''S''$ and $T''T''$ causes the vertical distance $O''Y''$ between points X'' and Y'' to be greater than the vertical distance between lines $S''S''$ and $T''T''$ —the new price is higher by more than the amount of the tax.

regain price equality with the other. If the two commodities are produced at constant cost, the untaxed commodity will take over its rival's market without any change in price. If the two commodities are produced at decreasing cost, the untaxed commodity will be able to take over its rival's market at a lowered price, since its own supply will be increased thereby.

But a tax levied on one of the competing commodities where both are produced at increasing cost, will not necessarily force it altogether off the market. Although part of its market will go to its untaxed rival, the increased output will raise the cost of production, and hence the price, of the untaxed commodity. At the same time, the reduction in output will lower the production cost of the taxed commodity, and thus the price at which it can be placed upon the market. At the point where the combined cost increase of the untaxed commodity and cost decrease of the taxed item equal the amount of the tax, a new price equilibrium for the two commodities will be established, higher than the original price, but not higher by the full amount of the tax. Thus a tax on one of two competing commodities produced at increasing cost is shifted to the consumers, partly through a price increase of the taxed item, partly through a related price increase in its untaxed rival.

A tax laid on one of two complementary commodities—items such as typewriters and typewriter ribbons whose consumption is necessarily joint—presents a second special circumstance. Purchases of the taxed commodity will fall off in accordance with the elasticity of its demand, and the effect upon its price will depend upon whether it is produced at constant, increasing, or decreasing cost. Meanwhile, the reduced demand for the taxed commodity will engender a reduction in the demand for its untaxed complement. In the long run, the circumstances of supply will determine the effect of this reduced demand for the complementary commodity. Price will remain unchanged if the untaxed complementary commodity is produced at constant cost. If it is produced at decreasing cost, the price will increase. Should it be produced at increasing cost, the price will decline. Since the demand is joint, any change in the price of the untaxed complementary commodity further affects pur-

changes of the taxed commodity, and involves still further readjustments of prices, purchases, and supply to reach a new market equilibrium.

When a tax is levied on one of two jointly produced products, such as butter and buttermilk, a third special situation is presented. It may be assumed that the original price of each joint product has adjusted itself to a point at which the entire supply of both joint products is consumed. An attempt to shift the tax by adding it to the price of the taxed product will reduce the purchases of that commodity according to the elasticity of its demand. This reduction of purchases will, in turn, cause a reduction in the outputs of both the taxed commodity and its untaxed joint product. Such a reduction in the supply of the untaxed commodity, unaccompanied by a change in demand, will give the producers the opportunity to raise the price to the point where the reduced demand caused by the price increase will just equal the reduced supply consequent upon a reduction in purchases of the taxed commodity. Thus a tax on one of two commodities jointly produced, besides its effect on the price of the taxed item, increases the price of the untaxed by-product, the degree of increase depending upon the relative elasticity of the demands for the two commodities.

Incidence of a tax on a commodity produced monopolistically

Perfect monopoly is rare in American industry, but a large element of monopoly enters through the control which particular firms hold over limited natural resources, through patent and contract rights running for periods of years, through the trade-mark goodwill attaching to the products of certain concerns and through trade agreements. Within limits, such quasi-monopolistic firms can set and maintain prices not directly related to the production costs of their products.

If a tax is levied on a monopolistically produced commodity for which the "monopoly price" is charged, the effect of the tax on the price will differ in degree, but not in kind, from the case of a competitively produced commodity. Very much like a group of competing producers, the monopolist will raise the price of his

In practice, the prices set by monopolistic or semimonopolistic producers are usually lower than the price that would produce the maximum "monopoly profit." Such producers can add the full amount of a tax to their original price with little or no injury to their profits. They would probably feel it right and proper that a special tax on their product should be passed on to the consumers. Commodity taxes on the products of monopolists and quasi-monopolists, then, are likely to be added *in toto* to prices.

Short-term factors in commodity tax incidence

Perfect elasticity of supply, and the possibility of its frictionless reduction, were presupposed in the preceding discussions of supply readjustments when demand is reduced by the imposition of a tax, and of the effects of these readjustments upon price. These conditions, however, are not encountered in practice. Such readjustments will take place in the long run, but for shorter or longer periods after the imposition of a tax, a different set of factors operates.

Reduced demand for a taxed commodity, because of a price increase, tends to be effected without friction and without lag. But the readjustment of supply to the reduction in purchases is not so smooth a process. Dealers must sell the supplies of the taxed commodity which they have on hand. Producers often find it impossible to convert their capital equipment—in which they may have heavy investments—to other lines of production. Both dealers and producers think in terms of "maintaining their markets," and they will seek every means—sometimes even those contrary to their true economic advantage—to avoid losing these markets because of a reduction in purchases consequent upon a price rise following the imposition of a tax.

Reduced profits for both producers and dealers, perhaps to the extent of converting annual profits into annual deficits, are likely to be the immediate result of a commodity tax. Such loss may

triangle DTT exactly in the same way as the rectangle $SXMM'$ in triangle DSS , represents the maximum monopoly profit to be obtained at the new supply cost. Since the line $N'N$ bisects line DT , and line MM' bisects line DS , the distance between points N' and M' must be exactly half the distance between points T and S —that is to say, the price of the taxed commodity is increased by exactly half the amount of the tax.

occur because producers and dealers decide to bear a tax themselves, rather than raise the original price of the taxed commodity. Although purchases will, in this event, remain at the old level, the profit of producers and dealers on each sale will be reduced by the amount of the tax. If the producers and dealers decide to add the tax to the price, however, the consequent reduction in demand will lead not only to reduced profits through fewer sales, but also to increased overhead costs on equipment thus rendered idle.

How long this period of reduced producers' and dealers' income will last depends upon the character of the industry. Some producers may find it possible to transfer readily to other, untaxed lines of production, or to reduce output without excessive piling up of overhead costs. Their period of readjustment is of short duration. Or, in the case of an expanding industry, the growth trend may quickly take up the slack of demand and production caused by adding the tax to the price. When productive activity is not transferable to other lines, however, readjustments of supply take a longer time, since they are accomplished by the deterioration of the equipment of the industry, and the failure of new capital to enter it because profits are below normal.

Business cycle trends are also an important factor in determining the ease and rapidity of a commodity tax shift. In a boom period, with consumer demand outrunning the capacity of an industry, a special tax on its product can be passed on in higher prices immediately. A tax imposed in recession times, on the contrary, would tend to remain a burden on the industry for as long as the period of slack demand lasted, since an increase of prices would probably cause an even greater loss by further strangling demand. In concealed fashion, however, special commodity taxes may be shifted during a recession by checking a price decline that would otherwise occur.

At the time of the tax levy, the producers of the commodity may enjoy some special temporary advantage which has enabled them to maintain a profit level above the general industrial average by more than the amount of the tax—they enjoy an “economic surplus.” If demand for the taxed commodity is at all elastic, the

producers will probably absorb the tax in order to maintain their markets. Since their profit level will remain higher than the general industrial average even after they absorb the tax, there will be no factors forcing a reduction in supply. The long-term effect of a tax on the price of such commodities is delayed until the period of special producers' advantage ends.

Related economic effects of commodity taxes

Where the elasticity of demand for a commodity is high, so that purchases decline more rapidly than its price increases, consumer expenditures on this commodity will be lower after the imposition of a tax than before. The purchasing power thus released will be expended on other commodities, and will tend to strengthen demand for them. Conversely, if the elasticity of demand for a commodity is low and purchases decrease less rapidly than its price increases, the imposition of a tax will cause consumers to spend more on that commodity than formerly. Demand for other commodities will correspondingly be weakened.

Meanwhile, as purchases of the taxed commodity fall off, the supply tends to be reduced and capital and equipment released from this line of production to other, and untaxed, lines. Since the influx of capital will operate to increase the supply of the untaxed commodities, if demand factors remain unchanged, the prices of these untaxed commodities will tend to decline. But, as was noted above, depending on the relative elasticity of the demand for a commodity, the imposition of a tax is likely to strengthen or weaken the demand for untaxed commodities. A strengthened demand for the untaxed commodities will offset the tendency of their increased supply to lower their prices. A weakened demand for the untaxed commodities will augment the tendency, on the supply side, toward lower prices.

These secondary effects of a tax imposed on a particular commodity involve such minute relationships of supply and demand, and operate so circuitously, that they may be ignored in considering the practical economic effects of taxes on particular commodities.

INCIDENCE OF A GENERAL COMMODITY TAX

A universal tax on all commodities, a comprehensive manufacturers' excise or a retail sales tax, for example, may for some purposes be considered a series of individual taxes on particular commodities. Starting with this premise, and applying the principles developed in the preceding section of this chapter, we would arrive at the conclusions that the tax would hardly affect purchases of necessities for which demand is relatively inelastic, that purchases of seminecessities having more elastic demand schedules would fall off slightly, and that purchases of semiluxuries and certain luxuries for which demand is highly elastic might decline sharply. Final prices for all commodities would be higher—in some instances by more than the amount of the tax, in others by less than the amount of the tax—than the pre-tax schedule of prices. And, taking into account the circumstance that the consumption of necessities outweighs the consumption of luxuries and semiluxuries, we should conclude that a general commodity tax, while reducing the *volume* of purchases, would increase somewhat the total of consumption *expenditure*.

But in arguing thus, we are omitting from consideration special factors which enter with telling weight when a general commodity tax is levied. Individuals with small incomes normally expend them entirely on consumption items—necessities primarily, a smaller proportion of seminecessities, and occasional semiluxuries. A general commodity tax cannot increase their consumption expenditures; it can only reduce the volume of commodities and services they buy. In effect, it reduces their true income. The basic character of their consumption demand is changed. According to the severity of the tax, they must cut somewhat their purchases of necessities, and still more their purchases of seminecessities and semiluxuries.

Although the line of reasoning is different, somewhat the same conclusion is reached for consumers in the middle-income range. Each individual divides his income between consumption expenditure and savings in proportions dictated by his personal tastes and

his general economic status. But for most middle-income individuals, saving is a more inelastic function than consumption expenditure. A general commodity tax, instead of increasing the monetary amount of their consumption expenditures and so reducing their savings, is likely to reduce their commodity purchases somewhat. Again we find that the tax reduces total consumption demand and modifies its basic character.

Some economists argue that a general commodity tax may be considered equivalent to a tax on consumption expenditure. As such, it reduces the value which the individual, and hence the consuming public generally, derives from money spent on consumption purchases, while money laid out for savings and investments retains its original value. Hence, by the law of diminishing returns, such a tax will cause consumers to decrease their consumption expenditure and increase their savings until the increasing utility of the former and the decreasing utility of the latter strike a new equilibrium. On the basis of this argument, middle-income individuals might increase their savings in the face of a general commodity tax, thereby reducing their commodity purchases by more than the amount of the tax, and altering their consumption demand schedules even more than was indicated in the paragraph preceding. This effect would be particularly noticeable if the general commodity tax was of an emergency character, and its duration was expected to be short; for the period of the tax there would exist a strong incentive for the middle-income group to hold down their expenditures and expand their savings.

Only among the small numbers of the rich, whose consumption expenditure is not conditioned primarily by income considerations, do we find the total of commodity purchases and its distribution unaffected by a general commodity tax. On the general market, however, the expenditures of this small group are completely overshadowed by the expenditures of the poor and middle-income classes.

We may conclude, in view of these considerations, that a general commodity tax reduces the total of consumer purchases. Therefore, it accentuates the elasticity of the demand for each commodity

in accordance with the degree of its original elasticity. Purchases of necessities, for which demand is relatively inelastic, may be reduced but slightly. But demand for semiluxuries and luxuries will suffer doubly. A distinct change in the consumption pattern of the community may ensue. What effect this magnified falling-off of demand for semiluxuries and luxuries will have on their prices will depend upon whether they are produced at constant, increasing, or diminishing cost.¹⁹

INCIDENCE OF PERIODIC TAXES ON DURABLE PROPERTIES

Durable properties and property rights—land, buildings, machinery, furniture, mortgages, corporate and municipal securities—may be taxed periodically. Such a tax cannot, of course, be paid in kind out of the property itself. If the property produces a periodic monetary income, such as rent or interest, or contributes to the earning of business profit, the tax may be paid out of this income. If the property yields its services directly to the owner without his receiving them in monetary form, as does an owner-occupied dwelling or an automobile maintained for pleasure driving, the tax must be paid out of other income received by the owner.

When and to what extent periodic property taxes are shifted, is one of the most difficult problems to which the student of Public Finance must turn his attention. Possibilities of shifting differ with (1) whether the tax is universal on all properties or limited to a specific class of properties, (2) whether the taxed property is held for personal use or is rented or employed in some business connection, and (3) whether the property is of a reproducible or non-reproducible character. We shall explore first the problem of a special property tax, differentiating wherever necessary between personal, rented, and business properties, and between reproducible and nonreproducible properties. This discussion of specific property taxes will lead the way to consideration of a periodic tax applying to all durable properties.

¹⁹ For an argument that general commodity taxes are shifted *backward* to reduce wages, interest, and rent, see Harry G. Brown, "The Incidence of a General Output or General Sales Tax," *Journal of Political Economy*, Vol. XLVII, 1939, pp. 254-262.

Immediate incidence of a special property tax

In no way can an owner shift a special annual tax imposed on a class of property commonly held for personal use—on pleasure automobiles, on owner-occupied dwelling houses. His personal ownership of such properties involves no business relationship that will enable him to shift the tax forward or backward to someone else.

Even when the taxed property is rented to a tenant instead of being held for personal use, the owner cannot immediately shift the tax by increasing the rental charge. Under normal circumstances this rental charge, like any other price, is established by the interaction of demand for the rented use of such property and the supply of such properties in existence. Neither the demand for such properties nor their supply is immediately affected by the tax. Hence, the tax cannot immediately affect the rental charge—unless, of course, the pre-tax rent was less than the maximum the landlord could warrantably have charged and obtained.

When property subject to a special periodic tax is used for business purposes, however, all or part of the tax may immediately be incorporated into the prices of articles or services produced through the use of a taxed property. Marginal as well as infra-marginal firms in each industry must pay a building tax applying to factories. To cover the tax, the marginal firms must raise their prices or fail. And if they fail, prices will be forced up anyway by the resulting reduction of supply. Some increase in commodity and service prices will ensue, though not necessarily by an amount exactly covering the tax on the factories. A monopoly enterprise owning such property will count the tax as an additional item of production cost. In accordance with the theory of monopoly price, it will raise its price schedule to secure maximum monopoly profit in light of the enhanced production cost.

Long-term incidence of a special property tax

No matter how long a special property tax lasts, an owner who employs taxed property for his personal use and satisfaction can-

not shift the tax. The all-important factor—business transactions—by which the tax might be passed on to someone else continues to be lacking

Long-term effects of a special property tax, where the property is used for business purposes, are no different from its short-term effects. Price schedule modifications warranted by the circumstances of demand and supply are made within a short period after the tax is imposed.

But long-term and immediate effects of a special periodic tax may be very different when the taxed properties are rented. In tracing this long-term effect of special periodic taxes on rented properties, we must distinguish between reproducible and nonreproducible properties. Included under the heading reproducible properties are buildings, machines, and all other durable items which, after they become unusable, can be replaced by identical or similar properties created by human effort. Land,²⁰ patent rights, and historic buildings are examples of nonreproducible properties.

In line with the accepted generalization, let us assume that the supply of land suitable for given uses, and the supply of other nonreproducible properties, is fixed. A periodic tax on these properties may reduce the net rents derived from them and hence, as we shall see subsequently, their capitalized values. But no matter how long the tax lasts, it cannot alter supply nor affect demand. The long-term effect and the immediate effect of the tax remain the same—the tax is not shifted.²¹

²⁰ In economic treatises, land is generally considered nonreproducible, but this is not strictly true. Arable land comparable with existing parcels can be produced at any time at the expense of cutting timber, draining swamps, irrigating arid regions, and applying fertilizer to infertile ground. Building sites comparable with existing parcels can often be created by grading or filling in uneven lots and by constructing streets and transit facilities. The distinction between land and reproducible capital properties is therefore relative rather than absolute. This consideration must be borne in mind as a qualification of the conclusions developed above.

²¹ If the theory of rents instead of the theory of supply and demand is used as a first premise, the same conclusion can be reached, with respect to a tax on rented land. The rent chargeable for any parcel of land is determined by the excess of its productivity over marginal land. Since the value of land, speculative variations aside, is the capitalization of its annual net rental, marginal land has no value to be subjected to taxation. If the landlords of supra-marginal land attempt to add their taxes to their rental charges, the resulting gross rentals will exceed the differential productivity of their parcels of land over marginal land. Tenants will desert supra-marginal properties for marginal land. To win them

But if a rented durable property is reproducible, a special periodic tax upon it will eventually affect the supply. Since the net rental return upon the property is reduced by the amount of the tax, it becomes less profitable than capital properties not subject to periodic taxation. Investment capital henceforth avoids the taxed property and seeks other, more remunerative placement. Old properties wear out and are not replaced. If demand for the properties in question is growing, new properties are not produced to meet the increased demand. Gradually the supply of the property diminishes relative to the demand. Under the circumstances, bids for the property must rise—prospective tenants must offer higher and higher rentals. At last the increased rentals cover the periodic tax, the net rentals represent a rate of return equal to that yielded by other, untaxed investments, and a return flow of investment capital leads to reproduction of the property in question. But through the higher rental, the tax has meanwhile been shifted by landlords to tenants.

Time allowance for this shifting process depends upon four factors: (1) the average "life" of the properties involved, (2) whether the current supply was all newly created or whether there was an appreciable number on the point of disappearing from the market, (3) whether demand for the properties is markedly inelastic or relatively elastic, and (4) whether demand is decreasing, static, or increasing. Depending upon the combination of these four factors, the process of shifting periodic property taxes from landlords to tenants may take a relatively long or short interval. In a rapidly growing community, a new house tax might be shifted into rents within the space of a year. In a community which had achieved full growth and had an oversupply of recently constructed houses, a house tax might not become fully embodied in rents for twenty or thirty years.

back, the landlords must reduce rentals to their old level, absorbing the tax themselves.

Or, more briefly, the nonshiftability of a tax on rented land can be argued on the basis of the "economic surplus" doctrine stated on p. 233 of this volume. The value of a parcel of rented land is normally a capitalization of its net rental. A tax on the land, therefore, is equivalent to a tax on its rent. Net rent is an "economic surplus." A tax on "economic surplus" cannot be shifted. Hence a tax on rented land cannot be shifted,

Capitalization

A parcel of land or other durable property yields a continuous stream of services to an owner who employs it for his personal wants, or a continuous sequence of rent receipts to a landlord who leases it to a tenant. Partly offsetting these gross service or rental receipts are recurrent costs of repairs and allowances for depreciation or obsolescence. Through the process of capitalization, the remaining net service or rental values determine the capital value of the parcel of land or item of property. At any time, the value of a piece of land or a durable property is the sum of this year's net service or rental receipts, plus next year's net service or rental receipts discounted at the current rate of return on capital to allow for postponement, and so on to the point where the discount for postponement practically balances the value of a year's net services or rentals. Or, to summarize the result of this calculation, the value of a durable property is the capitalization of its annual net yield at the current rate of return on capital.

Whenever or for such time as a special tax on a durable property cannot be shifted, it obviously diminishes the possible net services or rentals. And the capitalized value of these annual net services or rentals—or, in other words, the capital value of the property in question—is proportionately reduced. To the extent that a special periodic tax on land and other durable properties is not shifted, it is immediately capitalized as a reduction in the present value of the land and properties. Tax capitalization is permanent in the case of properties held personally, and of land and nonreproducible properties, where a periodic tax can never be shifted. In the case of reproducible properties, where the impossibility of shifting the tax is temporary, the tax capitalization is likewise temporary and diminishes as the time approaches for complete shifting of the tax.

When a property subjected to a nonshiftable periodic tax is sold, the purchaser naturally takes the tax into consideration in the price he offers. In calculating the net value of the services or rentals he will obtain from the property, he deducts the amount of the tax.

In so far as the price he offers is based upon a capitalization of the net services or rentals of the property, his offer will be lower by the capitalized amount of the tax. Thus the purchaser "buys himself free" of a nonshiftable tax. The current and capitalized future burdens of the tax fall exclusively upon the owner at the time the tax was imposed.²²

²² A hypothetical example is offered to illustrate the principles of shifting and capitalizing special taxes on rented properties.

A rented residence is worth \$30,000—\$15,000 for the lot and \$15,000 for the house. The rent has been \$1800 a year. The landlord has paid \$300 a year on a ten-mill property tax, so that his net rent has been \$1500 a year or 5 per cent on his investment. Now the tax rate is doubled, and the landlord has to pay an additional \$300 a year. Eventually he is able to shift the \$150 house tax to the tenant, in accordance with principles previously stated in the text. But the \$150 tax on the land value he must bear himself. The situation is presented in the following tabulation:

| | Ten-Mill Tax Rate | | | Twenty-Mill Tax Rate | | |
|-------------------|-------------------|----------|----------|----------------------|-------|---------|
| | House | Lot | Total | House | Lot | Total |
| Value of property | \$15,000 | \$15,000 | \$30,000 | \$15,000 | ? | ? |
| Rent | 900 | 900 | 1,800 | 1,050 | \$900 | \$1,950 |
| Taxes | 150 | 150 | 300 | 300 | 300 | 600 |
| Net rent | \$750 | \$750 | \$1,500 | \$750 | \$600 | \$1,350 |

A prospective purchaser checks over the values and rents of the property. He is willing to pay \$15,000 for the house, because the \$1050 house rent will give him, after taxes, a net rent of \$750 a year, or 5 per cent on his investment. But he will not pay \$15,000 for the lot, since the net rent, after taxes, of \$600 would represent only 3 per cent on the investment. He sets a price of \$12,857 for the lot. With the tax assessment brought down to that figure, and the tax correspondingly reduced, he will net \$643 a year, or 5 per cent on the \$12,857 purchase price for the lot. The capitalization situation is shown in the next tabulation:

| | Twenty-Mill Tax Rate Before Capitalization | | | Twenty-Mill Tax Rate After Capitalization | | |
|-------------------------|---|-------|---------|--|----------|----------|
| | House | Lot | Total | House | Lot | Total |
| Value of property . . . | \$15,000 | ? | ? | \$15,000 | \$12,875 | \$27,875 |
| Rent | 1,050 | \$900 | \$1,950 | 1,050 | 900 | 1,950 |
| Taxes . . . | 300 | 300 | 600 | 300 | 257 | 557 |
| Net rent . . . | \$750 | \$600 | \$1,350 | \$750 | \$643 | \$1,393 |

Incidence of a universal property tax

A universal periodic tax on durable properties differs in its effects from a special property tax both as to shifting and capitalization.

No shifting is possible with a universal property tax, not even in the case of rented reproducible properties. Since no untaxed forms of investment exist to compete with the taxed properties for investment capital, the flow of investment capital into taxed properties is unchecked. The supply of taxed properties is not affected by the tax, and hence the prices or rentals charged remain unchanged. The tax rests, immediately and permanently, on the owners and landlords.

Capitalization is likewise impossible. Net return on all properties is lowered by the tax. Since the capitalization ratio is neither more nor less than the rate of net return on property investments, it declines in identical proportion. Reduced returns on property and a reduced capitalization ratio leave capital values unchanged.

INCIDENCE OF PERIODIC TAXES ON NET INCOME ²⁸

Questions on the shifting of net income taxes are popularly dismissed with the generalization that such taxes are not shifted. Like most easy generalizations, this one is not strictly accurate. As will be shown, a general income tax applied to true net income can rarely be shifted. But if the tax is not general, or if "net income" as determined under the tax law does not coincide with "economic net income," possibilities of tax shifting enter.

Taxes on wages and salaries

The Physiocrats and the early Classical economists argued that wages and salaries tend to a minimum-of-subsistence level. A tax on wages and salaries, by forcing their "real" value below this minimum of subsistence, would cause laborers to die off from starvation, misery, and epidemics. Thus the supply of labor would be reduced in the face of an undiminished demand. Employers' com-

²⁸ A keen analysis of this subject is presented in Duncan Black, *The Incidence of Income Taxes* (Macmillan and Co, London, 1939)

petition for labor would cause wages and salaries to be bid up until their purchasing power, exclusive of the tax, once again reached a minimum-of-subsistence level. In the long run, a tax on wages and salaries would thus be shifted to employers.

Since modern income taxes generally include a minimum exemption, however, they cannot impinge upon minimum-of-subsistence incomes, and the old argument cannot apply. But even where an exceptional type of income tax, like the payroll taxes imposed to finance federal and state social security programs, includes no minimum exemption, we may not conclude that it is shifted to employers. In few lines of employment today are wages at a minimum-of-subsistence level. Custom, public opinion, and the collective bargaining power of labor have resulted in wage levels embodying varying standards of comfort. While standard-of-comfort wage levels have marked elements of rigidity, they provide a margin upon which taxes can encroach. A moderate payroll tax comes out of this margin between labor's income and its minimum of subsistence, and is borne by the wage- and salary-earners. Were the tax to absorb a substantial fraction of workers' incomes, labor might, by organized action, force employers to grant wage increases covering some part or all of the tax.

Taxes on business profits

Net business profits are, in the phraseology of the theorists, an element of "economic surplus." They are determined by prices and costs, without, in turn, exerting any effect on prices and costs. Hence a general tax which reduces these profits can in no way be shifted either forward to prices or backward to cost factors.

We reach the same general conclusion by using the theory of prices as a first premise for our argument. In any line of business where competition is truly effective, prices establish themselves at, or close to, the production costs of the marginal firms. Most of these marginal firms earn little or no profits, some sustain losses. As a group they pay practically no profits tax. Since the tax does not enter into the prices charged by these price-determining marginal enterprises, it cannot affect the prices charged by the supra-

marginal firms. A general business profits tax, or a general net income tax applying to business profits, is not shifted.

Should a particular line of competitive business—liquor manufacturing or distributing, for example—be subjected to a substantial special profits tax, a long-term possibility of shifting enters. The average return on capital invested in the business is reduced by the tax, presumably below the level for other untaxed business activities. New and replacement capital will be deterred from flowing into this business, forcing its contraction—or, at least, it will not expand as rapidly as those lines of business attracting new capital. Output will either be reduced or held below what would have been the normal expansion. Eventually this check on output, in the face of an unchanged demand for the product, will force prices upward until the tax is covered or, if supply factors are less elastic than demand, will force down rents or wages. The tax will be shifted either forward or backward.

A monopolist or a quasi-monopolist who is not subject to public control has the power to establish prices which produce a maximum “monopoly profit.” Any higher as well as any lower schedule of prices would produce lower profits. Any raising or lowering of an optimum schedule of prices with a view to “passing on” a profits tax would defeat its purpose, since such action would reduce profits.

In but two situations may a tax on a monopolist’s profits be shifted. Should a monopoly enterprise, prior to the imposition of a profits tax, have failed to bring its prices up to the maximum profit level, the tax may well lead to an increase in prices. Between the margin of the prior price level and the optimum level, a price increase to cover taxes will not reduce profits. Similarly, if a regulatory commission, having previously set railroad and public utility rates below the optimum level, should count a profits tax as a cost in determining rates, the imposition of a profits tax might result in higher railroad and utility rates without reducing company profits.²⁴

²⁴And, be it noted, a number of state public utility commissions formerly counted income taxes as costs—National Industrial Conference Board, *The Shifting and Effects of the Federal Corporation Income Tax* (New York, 1928–1929), Vol II, pp 84–86, there is reason to believe that these procedures are still followed

Taxes on rents and interest

A special tax on the true net investment return from some particular class of property or property right—on certain net rents, or “true” interest on certain types of monetary investment—will have the same effects as a special periodic tax on the property producing the return. Where the property is reproducible, or where mere monetary investment is involved, the lowered rate of return will discourage the investment of new capital. The supply of the taxed property or investment capital will decrease until the diminished supply, in the face of an unchanged demand for their services, produces an enhanced gross rent or gross interest sufficient to cover the tax. Thus a tax on certain rents will eventually be shifted to tenants of the properties, and a tax on the interest on certain investments will eventually be shifted to the borrowers. A special tax imposed on net land rents and on the returns from nonreproducible properties is normally not shiftable, since it usually cannot affect the supply of the land or properties in question. But it will be capitalized into lower prices for the land or properties.

A general tax applying to all net rents, net royalties, and “true” interest, as in the case of property taxes, will be neither shifted nor capitalized. With returns from all properties and all investments equally reduced, capital will not be diverted from any one field and into others, and the supply of any type of property or of investment capital in any field will not be changed. Capital values will also remain unchanged, since the rate of capitalization declines identically with the reduction in returns on capital investment.

So far in this analysis, it has been assumed that a special or general income tax was imposed only upon “pure investment return,” excluding all costs of property maintenance and allowances for depreciation and obsolescence, and also excluding all elements of investment return which represent “risk coverage.” As income and profits taxes are drawn, maintenance costs and depreciation and obsolescence allowances are excluded from the income concept, but “risk coverage” is not. And the return on most monetary investments is partially “risk coverage.” The more speculative the

investment, the larger is the element of "risk coverage" in the gross return. An income tax applied to the total return on monetary investments discriminates against the more speculative investments. Such discrimination discourages the flow of capital into placement offering the combined possibilities of large profits or heavy loss, and encourages the flow of capital into more stable, less adventurous channels yielding smaller gross returns. Eventually, borrowers of capital for more speculative enterprises must offer a higher rate of return to compensate for the tax. It has been shifted to such borrowers.

INCIDENCE OF TAXES PAID BY BUSINESS

For administrative reasons, many of our modern taxes are collected from business concerns, although they are not intended to rest there ultimately. Commodity taxes, whose incidence we have already considered, are collected from producers or distributors. A considerable proportion of property and income tax revenues is similarly collected from business concerns. Space considerations forbid our tracing the incidence of the scores of other taxes which legislative ingenuity has imposed upon business enterprise. We can, as a partial substitute for detailed inquiry, formulate several generalizations concerning the shifting of taxes collected in the first instance from business enterprises.

Business taxes in competitive fields

In general, any tax which must be paid by the marginal firms in any competitive field of business is wholly or partly shifted. This held true, as we have seen, in the case of commodity and property taxes. It holds equally true for special license taxes, capital stock taxes, gross income taxes, and others. Marginal firms must add such taxes to their prices or fail. And if they go out of business, prices for whatever they produced must rise in accordance with the elasticity of the demand and the conditions of its supply by the remaining firms in the field.

Marginal firms commonly have a higher ratio of capital and property assets to turnover than supra-marginal firms. Conse-

quently, a tax measured by capital or property items, when incorporated into unit output costs, means a greater addition to the unit costs of marginal firms than of supra-marginal firms. If demand for the output in question is relatively inelastic, such a capital or property tax can be more than passed on to consumers. Marginal firms add the full amount of the tax. Supra-marginal firms, in aligning their price schedules with those of their marginal competitors, are able to add somewhat more than a distributed share of the tax to each unit price. Their profits are actually increased by the tax.

As already indicated, any income tax, or excess profits tax, or undistributed profits tax, which does not affect marginal firms in a competitive field, cannot be shifted to consumers by the supra-marginal firms.

Business taxes in monopolized fields

For monopolies the rule is that a tax measured by any element other than net profit can usually be shifted. The tax changes the unit cost calculations for the monopoly, raising them to some new level. And every rise in the unit cost schedule of a monopoly establishes a new optimum price higher than the old one.²⁵ Whether the new optimum price is higher than the old by exactly the amount of the tax, or by more or less than the tax, depends upon elasticity of demand for the monopoly product and upon the circumstances of its production.

SHIFTING OF TAXES LEVIED BY LIMITED JURISDICTIONS

Many commodity and business taxes are freely shifted by the initial taxpayers to their customers, but this generalization is subject to a very important qualification peculiar to the United States. Except for the limited group of federal taxes, American taxes are not universal in their application. State *A*'s capital stock tax applies

²⁵ This statement is subject to a qualification. The theorist can conceive of a monopoly producing a commodity for which demand becomes completely elastic at a price slightly higher than the original one. In such case the monopoly could not increase the price for its product.

only to corporations organized or operating in State *A*. State *B*'s manufacturers' excise applies only to commodities manufactured or sold in State *B*. Concerns in other parts of the country are not subject to the capital stock tax of State *A*, and commodities produced or sold in other states are not subject to the manufacturers' excise of State *B*.

Retailers in the different states are not in active competition with each other, and these variations in state or local taxes rarely affect their marketing positions. But manufacturers and, to a lesser extent, wholesalers may compete in a national market. Shoes made by a St. Louis manufacturer who had to pay a normally shiftable turnover tax may compete in New York stores with shoes made by a Lynn manufacturer who paid nonshiftable corporate excess and income taxes. A New York machine manufacturer who paid a capital stock tax may be bidding for New Jersey customers against a Pennsylvania machine manufacturer who paid no such tax. Because forms and rates of taxes levied on competing business concerns and on the production of competing commodities vary as between states, the rules of tax incidence discussed in the preceding sections of this chapter do not always apply in full detail to American state and local taxes.

Commodity taxes

When one state taxes the production of an article which competes with identical articles manufactured in other states imposing no corresponding tax, this would appear to be a clear case of the levy of a commodity tax on similar but competing commodities, discussed in the preceding chapter.²⁶ But such is not the case. Here there is no problem of increasing the output of a competing untaxed commodity to replace part or all the output of the commodity driven from the market by the tax. Consequently, there is no variation in the production cost of the untaxed commodity to affect the sales prices of both the taxed and the untaxed commodities. Instead, if but one state or district taxes the production of a certain commodity, the producers in the taxed district must

²⁶ See pp 236-238 of this volume.

bear the tax as a reduction of their profits. If the tax drives them out of business, other producers with the same schedule of unit costs operating in untaxed regions will replace them. This substitution will have no long-term effect on the price of the commodity.

Business taxes

When competing manufacturing enterprises located in different districts or states are subjected to varying forms and rates of business taxes, the resulting discriminations and inequalities may bar the complete shifting of taxes which, if applied to all competing firms, might be shiftable. A manufacturing firm located in State *A*, subjected to a heavier combination of ordinarily shiftable taxes than a competitor in State *B*, cannot include the taxes in the prices charged without losing part or all of its market to its competitor in State *B*. It must absorb the taxes as a reduction of net profits, regardless of economists' arguments for the ordinary shiftable of such taxes. Should an excess of unshiftable state or local taxes drive a manufacturer out of business, there need be no reduction in the supply of the commodities to force the price upward. He can be replaced by a manufacturer located in a lighter taxing state who bears no excess of unshiftable taxes.

CHAPTER XI

Taxation and the General Economic System

UNTIL very recently, fiscal economists had little to say about the effects of tax systems upon the general economic structure. Such effects were acknowledged—after all, any discussion of shifting and incidence of taxes indicated that taxes were likely to modify consumption demand for commodities and services, and the production necessary to meet such consumption demand. Critics of particular taxes would charge that they discouraged initiative, and so had detrimental effects on the country's economy, or that they checked saving and the accumulation of capital. But no coordinated body of thought on these subjects was developed.

During the past decade, both in Europe and America, many prominent economists have devoted attention to this tremendous subject. Impetus to this line of analysis in Europe was provided by the necessity for financing armament programs. The nations of Europe were taxing themselves as never before in their history, and the consequences of mistaken policy would now be disastrous whereas previously they would have been only detrimental. Interest on this subject in the United States was awakened by the New Deal fiscal policies. Deficit financing was adopted by the federal government not merely as an easy way out, but with the express objective of stimulating recovery by refraining from taxation. The undistributed profits tax of 1936 was adopted not only as a means of raising revenue, but also as an instrument of control over corporate policy. When an "all-out" defense program was initiated in 1940, to be financed two-thirds by taxation and one-third by borrowing, the defense tax program was seen as an important method of controlling national consumption and production.

Analysis in this field is still too new, too controversial, to have provided a body of knowledge upon which there is general agreement. Instead we have a scattered group of topics, hotly debated. In many cases, the "first principles" adduced for or against conclusions in this field are unproved and often unprovable generalizations, mere dicta sometimes, drawn from other social sciences which are themselves undergoing revolutionary reconsideration. There is a wide diversity of such generalizations from which to choose. Often enough these "first principles" are flatly contradictory, so that contradictory conclusions about tax effects can be obtained according to the choice made among "first principles." Thus some economists claim that excessive saving is a factor in bringing on recessions, while others insist that saving can never be excessive since it is transmuted into investment, which is a business stimulant and the foundation of national economic growth. From the first generalization could be derived support for capital gains taxes, death taxes, and money-and-deposits taxes, which absorb or discourage saving; the second leads to the conclusion that such taxes are harmful.

The task of the student of Public Finance at the present time is to recognize the basic assumptions that lie behind theories upon the economic effects of taxation, and to credit the resultant conclusions according to the relative validity of their first premises. Lack of inductive verification of a fiscal first premise derived from the fields of economics or social psychology does not necessarily render it false. Although open to challenge until proved, such an assumption may still serve as a valuable working hypothesis embodying strong elements of probability. Subsequently it may be disproved; the theories based upon it must be discarded. Or elements of confirmation may develop, with possibly some refinements on the initial crude generalization; then the way is cleared for a small further advance in the science of fiscal economics. Slowly but definitely a small nucleus of pragmatic knowledge in the field is being accumulated, amid a penumbra of groundless dogmatizing. The pages that follow will survey this knowledge, with side glances at some of the bordering controversies.

TAXATION AND DISCOURAGEMENT OF INITIATIVE

Taxing the incentives to economic activity, it is frequently argued, discourages initiative and so retards economic progress. Men work, the argument runs, to earn incomes, particularly large incomes. Reduce these incomes by progressive income taxes, by nonshiftable business taxes, by levies on investment return and accumulated capital, and the incentive to work is diminished. Set these tax rates high enough, and the incentive to labor will be so obliterated that economic progress will suffer.

Such arguments are premised on two assumptions: (1) that the only incentives to labor and business activity are pecuniary, and (2) that the demand for income and wealth is elastic. Few economists today would support a bold and unequivocal statement of the first assumption. Nonpecuniary motives are recognized as important stimuli to many kinds of work—particularly professional and managerial work. Men work to earn incomes, but they also work as a matter of habit, because of quasi-moral compulsions, and because they have a creative interest in their work. Where nonpecuniary motivations are operative, the reduction of income by taxation will not lessen incentives to work. Moreover, the desire for income may not, itself, be purely economic. Many individuals value their large incomes primarily because of the social position thus assured. If incomes at each successive income level are reduced in some related degree by a tax, the recipients still enjoy the same social ranking, and the incentive to work in order to maintain relative social rank still remains.

Further, the assumption that amount of income determines desire for income as a work incentive itself rests upon a prior assumption—that this desire for income is elastic, or in other words that as the cost of procuring net income is increased by taxes, the desire to achieve any level of net income will be reduced. Possibly this assumption is sound, in many cases. But a strong argument can also be made out for the contrary assumption—that in many cases demand for income is inelastic. From this contrary assumption would be derived the conclusion that taxes on earnings induce in-

creased labor and business activity. An individual, it may be argued, having determined to earn a given income, will work the harder in order to offset a reduction occasioned by a tax. Psychology does not definitely indicate which basic assumption is the sounder. In view of the uncertainty of his first premises, the economist must withhold judgment.

There is one tax situation, however, which unquestionably checks incentive to create new enterprises or enlarge existing ones. New business ventures involve much greater risk of loss than continuation of established enterprises. Without the prospect of exceptional profit if success crowns the venture, there can be little incentive to take the risks that surround new ventures. If a heavy income tax or, even more to the point, a high-rate excess profits tax is certain to skim off a large or major part of the substantial gain on successful new ventures, the odds are loaded against the effort. This effect of business income taxes has long been recognized, but no remedy or palliative has been developed. In the case of excess profits taxes, where the effect is even more drastic, a somewhat higher "normal profit credit" may be allowed for new enterprises. The American excess profits tax of 1940 took account of this situation and its relation to expansion of industries essential to the defense effort by allowing extra large depreciation deductions on new investment for defense purposes.

EFFECTS UPON CONSUMPTION, SAVING, AND INVESTMENT

Every tax, no matter what class or group it burdens, absorbs purchasing power that either was already income of the burdened class, or would have matured into income. Income taxes and shifted taxes that are eventually embodied in higher prices for expenditure items are illustrations of taxes that absorb realized income; a non-shiftable business tax that raises costs and hence reduces profits is an example of a levy that absorbs purchasing power that would eventually have been recorded as income.

Expenditure of the tax receipts by the government generally pours this purchasing power back again into the national income

stream.¹ In its passage through government channels this purchasing power produces immaterial governmental services or capital properties or, in the case of transfer expenditures,² is bypassed directly back to the general national income stream. From this it might appear that the combined effect of taxation and governmental expenditure is to increase the national income, since the tax funds had previously appeared as income and now the governmental expenditures count again as income or contribute to the profit of their recipients. This conclusion overlooks the consideration that had these elements of purchasing power not been absorbed by taxation, they would have been privately expended and invested, and so have returned by various channels to swell the income stream. The combination of taxation and government expenditure may increase or decrease the total national income stream somewhat, according to whether governmental expenditures are more "reproductive" than the corresponding volume of private expenditure would have been, but we have no means for judging this effect.

But, although taxation and governmental expenditure may not exercise much influence on the global total of national income, they can profoundly affect the employment of that income as between consumption expenditure on the one hand, and saving and investment on the other. The purposes of governmental expenditure themselves constitute an important factor in the production and utilization of consumption items and in the creation of capital properties, as was discussed in Chapter II.³ And, given any particular pattern of governmental expenditure, the character of the tax system will have further effects upon consumption, saving, and investment.

¹ There are three cases where there is no return of purchasing power absorbed by taxation to the general national income stream. The first case is where the tax revenues are used to make payments in foreign countries, as when the United States supported an expeditionary force in Europe during World War I. The second is where payments on interest or principal of governmental debt are made to foreign holders of the securities. The third and most important case is where a government is paying off elements of domestic debt held by commercial banks; since such bonds were bought with bank-created credit, their retirement is accompanied by a credit contraction. This third case is considered more fully on pp 660-661 of this volume, which cover the economic effects of borrowing and debt retirement.

² See pp 39-40 of this volume.

³ See pp 38-41 of this volume.

Effects upon consumption expenditure

Whether a tax will absorb purchasing power that otherwise would have been devoted to consumption expenditure, or whether it will absorb income that otherwise would have been saved and invested, is determined not by the particular type of tax but by the income class that ultimately bears the burden of the tax, and sometimes by the economic character of the original taxpayers. A tax on expensive jewelry, although a commodity tax, would probably reduce saving and possibly investment. Lowering the personal exemption of the federal income tax, by contrast, would exercise most of its effect on consumption expenditure.

Our first premise in this line of reasoning is the findings upon the relative elasticity of consumption expenditure and saving for different income classes. The lowest income classes, that live from hand to mouth, and that in many cases permit the mouth to anticipate the hand through instalment buying, do not save. Any taxes borne by them obviously directly reduce their consumption expenditure. But all income classes above the lowest both spend and save. The weight of evidence would indicate that for families up to the \$10,000 income range, saving is relatively inflexible. They operate on specific or unformulated savings budgets—a fixed annual amount allocated to insurance, another to mortgage payments, and still another to building up a moderate “capital.” Their savings being relatively inelastic, their expenditures are the flexible item. Taxes that reduce their net incomes or increase the prices they must pay, simply reduce the amount of their purchases.

The larger the family income, the more likely it is that a family group will insist on holding themselves to an established standard of living, and let fluctuations in income or living costs vary their savings. A family with a \$25,000 income that had been spending \$20,000 and saving \$5,000, finding its purchasing power lowered \$4,000 by reduced income or increased prices, might cut its expenditure to \$18,000 and its saving to \$3,000. To go further up the income range, a family with a \$100,000 income that had been spending \$60,000 and regularly investing the balance, faced with a \$25,000

reduction, might well continue to spend its \$60,000 and let its saving and investing fall to \$15,000. Taxes of any sort, then, borne by the higher income classes are likely to have little effect on consumption expenditure unless they approach the confiscatory level.

We have, then, the general proposition that any tax borne to any considerable extent by the mass of individuals with small and moderate incomes will reduce the country's consumption expenditure. Commodity taxes like tobacco and liquor taxes and retail sales taxes have this effect. So also do property taxes paid upon small farms and ordinary dwellings. Business license charges and taxes of all sorts that reduce the earnings of retailers and other small business men, likewise reduce consumption to a considerable extent. The same is true of personal income taxes to the extent that they apply to small incomes. Payroll taxes, for so long as they exceed the amounts paid out by the federal government in old-age pensions and by the state governments in unemployment insurance, would have a particularly depressing effect on consumption expenditure but for the circumstance that they apparently have induced many workers to give up saving "for a rainy day," and thus are reducing savings income as much if not more than expenditure income.

This effect of particular taxes on consumption expenditure can be utilized as an instrument of national economic policy during a war period or a period of preparation for war such as began in 1940. Under such circumstances, the industry of the country is called upon to produce military supplies, not merely to some convenient extent over and above its production of commodities and services for civilian consumption, but to the maximum of its resources. With "all-out" war or defense efforts being made, the maximum of the country's productive resources becomes insufficient to meet government demands plus the ordinary civilian demand. To make the problem worse, the expansion of production and employment to capacity augments the income flowing into private hands and available for consumption expenditure; thus at the very time that the government is demanding that many sectors of industry turn from civilian to military production, the people of the country are demanding a greater production of civilian goods than

ever before. There are a number of ways of meeting this situation—by a system of production “priorities” which provides for full satisfaction of national defense needs before industry can turn to civilian production, by a system of “rationing” of retail sale of consumer items, by absorbing the excess purchasing power in consumers’ hands by inducing them to invest it in government bonds, and finally by taking this excess of consumer purchasing power through increased taxation.

When a country is bending its every effort towards prosecution of a war or towards preparation for the eventuality of war, all of the above four methods of controlling civilian purchasing demand must be exercised. They complement each other and in conjunction are more effective than any one by itself. But absorption of civilian purchasing power by heavy taxation or by borrowing is essential to the success of the first two techniques. Without such absorption of purchasing power, the pressure of expanded civilian purchasing demand upon the country’s industry is so intense that priorities and rationing become difficult to enforce. Taxing away purchasing power has several advantages over borrowing it. Borrowing leaves the country saddled with debt and only postpones the agony of actually paying for the war or defense. Moreover, voluntary loans absorb the purchasing power of the patriotic, but leave willful and self-indulgent slackers free to exercise their detrimental influence against the nation’s defense effort. And finally, the government’s attempt to borrow the excess purchasing power of the country may defeat itself if the bond buyers use their bonds as security for bank borrowings, and thus regain through the creation of bank credit the purchasing power they had previously transferred to the government. Taxes as absorbers of purchasing power suffer from none of these defects. Taxation to the extent of brutal severity, grinding down upon the low income groups as well as slashing the incomes of the rich, must be the foundation of war finance.

Just as imposition of taxes that reduce consumption expenditure can be an important element of national policy when such reduction is important, so failure to impose such taxes or the repeal of such taxes previously imposed can be methods of stimulating con-

sumption expenditure when such stimulation is desirable. Had the New Deal expenditures on "relief and recovery" been financed and balanced by taxes that absorbed consumption income, the billions of dollars of purchasing power poured into the economic system by the federal expenditures would have been offset by billions of dollars of purchasing power taken out of the system by the taxes, and the net "recovery" effect of the expenditures would have been nil. Deficit financing—deliberate refraining from imposing taxes that would absorb purchasing power otherwise available for consumption expenditure—was necessary to give the "relief and recovery" expenditures their "recovery" effect.

Deliberate freeing of national purchasing power by repeal of consumption-reducing taxes should be a preplanned element of federal financing at the close of a war or long period of armament procurement during which consumption expenditure has been restricted.⁴ The tremendous economic dislocation produced then by the shift from a military to a peace economy is likely to set off a severe recession. Wages, salaries, profits, and all other incomes based on the armament effort suddenly cease, and with their disappearance the flow of purchasing power contracts abruptly. The disastrous effects of this contraction can be offset to a considerable extent if the government at such time reduces or repeals a large part of the consumption-constraining taxes previously levied to finance the armament effort. Such repeal is well worth while, even if it results in a temporary heavy deficit that has to be financed by sale of securities to banks, which gives the federal government purchasing power without reducing the people's buying ability.

Effects upon saving and investment

Nineteenth-century economists often charged that taxes on capital values—property and inheritance taxes—impeded economic growth by destroying national capital. We may dismiss this argument since it is based on a misunderstanding of the economics of tax payment. Under nineteenth-century and present-day systems of tax administra-

⁴ See William J. Shultz, "Defense Finance and Postwar Objectives" in The Conference Board, *Essential Facts for Fiscal Policy* (the Board, New York, 1941), pp. 118-123.

tion, all taxes—even those based upon capital values—are paid out of current income or income not yet converted into capital plant. A moderate property tax will be paid either out of the income produced by the taxed property or out of other income received by the owner. A heavy death duty or a capital levy will be paid by selling part of the taxed estate to purchasers who make payment either from current incomes or from savings not as yet applied to permanent placement. Sale of property in this fashion to raise funds for tax payment constitutes “dissaving” by the seller, which offsets in the national economy the saving previously accomplished by the buyer, so that the total saving of the community is correspondingly reduced. But no destruction of existing capital properties is involved.

But the nineteenth-century economists were on the trail of a real issue—do taxes differ in their effect upon saving? The answer is categorical—they do. And by affecting saving, they influence one of the factors that determine new investment,⁵ which in turn is a major element in national economic growth. In broad terms, we may say that saving is retarded by taxes which (1) rest primarily upon high-income classes, (2) reduce the return upon invested capital, (3) penalize the procedure of saving or investment, and (4) absorb saved income before it is invested in new enterprise.

The case of taxes bearing upon the higher-income classes has already been considered.⁶ Because consumption expenditure of the rich is rather inflexible in character, while their savings are the elastic difference between their incomes and their expenditures, any tax bearing upon the richer elements of the population tends to reduce the nation's saving. Steeply graduated personal income taxes have this effect. So do corporation income taxes, excess profits taxes, and other taxes that reduce corporate net income, since a large fraction of corporate dividends goes to wealthy stockholders who reinvest their receipts; of course, to the extent that the dividend receipts of poor stockholders are reduced by such taxes, consumption expendi-

⁵ Note that taxes may affect investment in other ways than by affecting saving. On p. 262 we considered the influence of taxes which penalize new ventures and thus discourage investment in new ventures.

⁶ See pp. 265-266 of this volume.

ture is likely to be reduced. Taxes on club dues, yachts, and other luxury items, by increasing the money expenditures of the richer elements of the population, reduce the saved margin between their total expenditures and their incomes.

An important though not exclusive motivation for saving is the hope of return from capital investments. Any factor—a property tax, or an income tax applying to investment income—which reduces the anticipated return from capital necessarily discourages somewhat the impulse to save. Is the discouragement substantial? Although we have no means of measurement, it would be a fair guess that at ordinary rates of property, income, and business taxation, it is not. But to the extent that a tax system shifts from expenditure and earned income to property and property income, we may conclude that it tends to impede saving.

Savings will, of course, be discouraged if a tax directly penalizes the procedure of saving. The undistributed profits tax of 1936,⁷ which imposed a substantial tax on corporate profits not distributed to shareholders through dividend payments, is a clear illustration of such a tax. Undistributed corporate profits are an important item of national saving. Many corporations which otherwise would have accumulated and invested their profits were induced by this tax to distribute at least part of them through higher regular dividends and special dividends. Some shareholders probably considered these extra dividends as a capital item and reinvested them just as the corporations would have done. But in many cases they were viewed as windfall income, and were spent on extra luxuries which otherwise would never have been purchased. It is estimated that, had an undistributed profits tax been operative during the 1920's, national savings would probably have been reduced by several hundred million dollars annually.

Another example of a tax that would expressly penalize saving is the money-and-deposits tax proposed during the 1930's,⁸ which

⁷ See p 501 of this volume. A concise exposition of this view of the undistributed profits tax, with supporting statistics, is presented in Donald W. Gilbert, "Undistributed Profits and Business Fluctuations," *Taxes*, February 1938, pp 72-74.

⁸ See Arthur Dahlberg, *When Capital Goes on Strike* (Harper & Bros., New York, 1938), and William J. Shultz, "The Proposed Currency-and-Deposits Tax," *Bulletin of the National Tax Association*, Vol XXIV, March 1939, pp 182-184.

would have imposed a rate of one per cent or more a month on currency on hand and funds in checking accounts at the close of each month. Proponents of this tax argued that it would induce people to spend their income as received or place it immediately in productive investment, rather than allow it to accumulate in dormant cash or deposit form. By thus encouraging expenditure and punishing saving that did not eventuate immediately in investment, it was hoped that the velocity of money would be accelerated and that the resulting additional business activity would help lift the country out of depression.

Finally we have the case of taxes that absorb saved income before it is invested in new enterprise. This is not quite the same situation as taxes that fall upon the rich and which absorb income that otherwise would have been saved and so might have been available for investment. In the case now under consideration the income has been saved and put aside, and then is absorbed by the tax. This can happen only indirectly. As mentioned earlier, when part of an estate is sold to pay the death taxes on it, the buyer's savings are diverted from the possibility of new investment to the estate and then on to the government. Exceptionally heavy war or defense taxation can also have this effect. Some individuals, feeling that the heavy rates are likely to last only a year or two, and not wishing to cut their standard of living to the extent that payment of the tax out of current income would compel, may draw upon savings accounts or sell some of their investment holdings to provide funds for tax payments.

Classical economics held that savings and the accumulation of national capital were synonymous, hence a tax which impeded saving retarded the growth of national capital; this was held *per se* bad. The weight of economic opinion probably still leans to the same view.⁹ But dissenting voices are growing in number and authority. There is a wide gulf between current savings and growth of capital equipment. Sometimes, as during the middle 1930's, savings may lie dormant in "hoards," and there may be a long lag before they

⁹ An effective recent presentation of this view is given in Harley L. Lutz, *The Business Man's Stake in Government Finance* (Stanford University, 1940), pp. 12-13.

ripen into prosperity-stimulating investment. In boom periods a considerable proportion of the nation's savings is detoured into the speculative market with consequent capital inflation, and never accomplishes any creation of new capital properties.¹⁰ Furthermore, as our American economic system is now constituted, an overexpansion of capital equipment may at times be a greater evil than retarded expansion. Rapid technological improvement may produce an unhealthy proportion of interim unemployment, and an expanded volume of goods so priced that it cannot be absorbed by current consumption income. Clearly, it is by no means settled whether taxes which retard saving are categorically inadvisable. Data for the formulation of any ultimate judgments are as yet lacking.

The limit of taxable capacity

Many fiscal writers have dealt with the subject of the limit of taxable capacity—the proportion of national income that can be absorbed by taxation. Some have set arbitrary figures, fifteen per cent or twenty-five per cent, and have warned that any higher proportion was impossible or that disaster lurked beyond such a limit.

Such an approach to the problem is foredoomed to failure, since it attempts to deal with taxation as an isolated phenomenon, unrelated to the governmental expenditures financed by the taxes collected and to borrowing as an alternative or complementary method of obtaining funds for government use. As was stated several times earlier in this volume, and as cannot be repeated too often, the three elements of Public Finance—governmental expenditure, taxation, and borrowing—must be considered together as to their joint effect upon the national economy. Any statement about the effects of taxation must be subject to assumptions as to the interrelated influence of governmental expenditure and borrowing.

In general, a government can take through taxation a proportion of national income equal to the proportion of the productive effort of the country that can be occupied in creating governmental serv-

¹⁰ This line of reasoning is more fully developed in William J. Shultz, "Taxes That Retard Savings," *American Scholar*, Vol. VII, 1938, pp. 309-318.

ices, plus an amount that will balance its "transfer" expenditures. This is merely another and possibly more complicated way of saying that the limit of taxable capacity is set, not in the tax field, but by the possibilities of governmental expenditure. In Chapter I it was stated that the theory of governmental expenditure limits "is too elastic to have much meaning except in war or other emergency periods."¹¹ If governmental expenditures over a period of years amount to fifteen per cent, taxes not only can but should constitute a corresponding proportion of national income received, unless deficit financing is specifically undertaken for a period to reinforce the effect of private purchasing power on the national economy. The same conclusion holds if the proportion of government expenditure to national income is twenty per cent, or twenty-five per cent. Borrowing and debt retirement may cause the tax proportion to vary somewhat from the expenditure proportion for short intervals, but in the long run the two must balance.

When the emergency of war causes government expenditure to constitute a third, or a half, or even a higher fraction of the national economy, then taxation plus borrowing must take a corresponding fraction of the country's purchasing power from the civilian population. If an "all-out" rearmament program or the demands of war should carry governmental expenditures in this country to forty billion dollars, or sixty billion dollars—fantastic figures that are, alas, within the range of early possibility—disaster would lie, not in taking corresponding sums from the people of the country by taxation and borrowing, but in the avoidance of such drastic action.

"Taxable capacity" by itself is a meaningless concept. "National sacrifice capacity"—the maximum proportion of their purchasing power that the people can be made to surrender to their government in war time or during other emergency periods—is a significant term and may in some unfortunate future be an important consideration in government policy. It is equivalent to the "national war potential" discussed earlier in this volume, and this in turn equals the difference between the maximum productive capacity of the country and the minimum level of consumption to which the people

¹¹ See p. 26 of this volume.

can be held for the duration of a war or other emergency. How much of this "national sacrifice capacity" should be tapped by taxation and how much by borrowing is a matter of administrative expediency.

REGULATORY TAXATION

Broadly speaking, every tax which touches business relationships is "regulatory." A tax which raises the price of a commodity deters its sale and hence its production, and possibly beneficially affects the sale and production of commodities directly or indirectly competing with the taxed item. A tax which imposes a discriminating burden on any type of business or class of business organization upsets the pre-existing competitive equilibrium. Special exemptions in any tax constitute a sort of bounty to the exemptees, and alter the business pattern.

Fiscal scholars have always recognized that taxes and exemptions are a modifying element in the economic structure. The controversy is not over the fact of modification, but over whether it should be deliberate.

Legislators have not been unaware of the economic modifications accomplished by certain types of taxes. Occasionally in the past, with increasing frequency in recent times, they have enacted taxes primarily or even exclusively for their "regulatory" effects. The objectives of these deliberately regulatory taxes or exemptions may be classified as (1) to control certain elements of consumption, (2) to control certain elements of production or distribution, (3) to control business conduct, and (4) to control the general economic system. In some foreign countries we find cases of bachelor taxes and other levies specially devised to encourage marriage or otherwise control the social system, but this fifth type of tax control has not so far appeared in American legislation.

Controlling consumption

Consumption of commodities and services can be controlled by taxation in two ways: purchase of harmful commodities may be discouraged by discriminatory taxes, and socially desirable consumption

can be stimulated by suitable exemptions to general sales taxes where these are in force.

The federal tax system offers several interesting examples of regulatory taxes which produce hardly any revenue but which discourage the sale of harmful items. Opium manufactured for smoking purposes is taxed \$300 per pound; sales of marihuana for nonmedicinal purposes are taxed \$100 per ounce. Sales of machine guns and certain firearms to unlicensed parties are taxed \$200 per transfer. Payment of these taxes would make the prices of narcotics and firearms practically prohibitory; nonpayment gives the federal government, which does not possess police powers enabling it to forbid manufacture and sales of these items, power to prosecute for tax evasion.

The so-called "sumptuary" taxes, like the federal tobacco and liquor excises, represent a partial approach to consumption control through taxation. Here the idea is not to prohibit consumption of articles deemed obnoxious to public morals,¹² but rather to penalize their purchase by making them more expensive—and at the same time bring a welcome item of revenue into the public treasury. The entire idea of "sumptuary" excises is self-contradictory; if they effectually reduce consumption of the taxed articles they must fail as revenue producers, whereas if they succeed as revenue producers they have failed as consumption controllers. But this self-contradiction has not interfered in any way with the persistence of the idea.

Oleomargarine taxes, imposed by the federal government and twenty-nine states, represent another perversion of the regulatory principle as applied to consumption of harmful articles. In the 1860's, dairy farmers found that oleomargarine, made from animal fats and vegetable oils, was beginning to offer serious competition to butter. They claimed that its consumption was harmful. Actually it is but slightly inferior to butter in nutritional and other health elements, and on a cost basis is more nourishing than butter. But Congressmen and Senators did not dare offend the bloc of votes repre-

¹² Only a trifling number of people could be found today who consider smoking immoral, the disapprovers of liquor drinking are more numerous, but still a minority of the population. None the less the tradition has persisted, at least for fiscal purposes, that tobacco and alcoholic liquor pander to the weaknesses of the flesh, and that indulgence in them should be penalized.

sented by the dairy farmers, and taxed oleomargarine two cents a pound. Now the federal tax is ten cents a pound, upon which are superimposed state taxes of five, ten, and fifteen cents, driving oleomargarine completely off the American market.

Regulatory excises can perform a valuable function in war periods or "all-out" defense periods, a consideration heretofore unexplored by fiscal economists or legislators. At such times it may be desirable to reduce to a minimum civilian purchasing of certain materials like aluminum needed for armament purposes, and of the output of industries like automobile manufacturing whose facilities can be converted to armament production. Reduction of civilian purchasing power by taxes that absorb expenditure income merely contracts the global total of such purchasing power without necessarily channeling it away from particular products. Such channeling can be accomplished by regulatory excises. A 100 per cent, 200 per cent, or 500 per cent sales tax could be imposed on "nonessential" items made of aluminum. Such a tax would produce little revenue but it would drastically discourage purchases of aluminum items. Thus there would be a minimum civilian demand for aluminum products to interfere with armament demand for the metal. Similarly, a 10 per cent, 25 per cent, or 50 per cent excise on automobiles could be levied to reduce private buying of cars to the number still being produced after conversion of some automobile facilities to armament production. Such channeling of remaining civilian purchasing power *away* from products and industries employed in armament production would have the further desirable effect of channeling remaining consumption expenditure *toward* products and industries which cannot be converted to the armament effort, yet which should be kept in operation since their elimination would in no way contribute to the armament effort and would merely constitute economic waste.

Controlling production and distribution

Prohibition of harmful commodities, practices, and services can be accomplished by taxing the producer as well as the product. The federal opium and firearms excises are further enforced by heavy license taxes on the manufacturers, exemptions being allowed to

those who produce under regulation exclusively for authorized uses. A federal tax of two cents per hundred is imposed on white phosphorus matches, not because they are harmful to the users, but because the process of their manufacture is injurious to workers. Somewhat analogous to this match tax were the attempts in 1916 and 1918¹³ to end child labor by taxing products of such labor when they entered interstate commerce. One of the most famous prohibitory taxes of this type is the ten per cent federal levy on state bank note circulation, imposed in 1865. The injury to be avoided in this case was the weakness of a currency system composed in large part of the notes of the poorly regulated state banks.

Customs duties are in essence commodity taxes on one group of items—imported articles, while a competing group—domestic articles—are tax free. As we saw earlier,¹⁴ in such case the untaxed item takes over part, or even all, of its taxed competitor's market. Thus a "protective" tariff, one with rates on particular imports high enough virtually to exclude those items, acts as a regulatory tax to wipe out the competition of foreign-made articles and preserve the American market for domestic manufacturers. As with the other regulatory levies already noted, the success of a "protective" tariff is measured by its failure to produce revenue; a substantial yield from any "protective" rate in a customs duty would be indication that the articles covered were entering the country in volume, which would mean that the "protection" was inoperative.

The chain-store taxes now found in twenty-two states¹⁵ illustrate a perversion of regulatory taxation. The avowed purpose of the tax is to handicap chain stores in their competition with independent dealers. Many arguments have been advanced by proponents of these taxes to prove that chain stores are harmful to the communities in which they operate, or to establish that they enjoy discriminatory advantages under other elements of the tax system, but upon examination these arguments prove to be specious. This is a case where pressure group activity has coerced legislatures into using the

¹³ Declared unconstitutional in *Hammer v. Dagenhart*, 247 U. S. (1918) 251, and *Bailey v. Drexel Furniture Co.*, 259 U. S. (1922) 20.

¹⁴ See pp. 236 ff. of this volume.

¹⁵ Chain-store taxes are described on pp. 530-531 of this volume.

premiums. The lure of apparently "getting something for nothing" often led customers to buy inferior values or pay higher prices in the "trading-stamp stores," and the practice is generally held to constitute an unfair type of merchandising promotion. Many states have abolished the practice under their police powers. In others, the courts held that the police power could not prohibit such transactions, and these are the states that have turned to trading-stamp taxes. In Washington and Montana, for example, a store using trading stamps must pay a special annual \$6000 tax. In the face of such a tax, few retail establishments find that trading stamps pay.

Suggestions have been made that special corporation tax rate reductions be allowed to corporations maintaining certain standards of employment during recession periods, or that penalty rates be imposed on enterprises that have wide seasonal fluctuations in employment. It is difficult at first glance to see how these "incentive" proposals could be put into practical effect, but if a workable statute could be formulated it would open another useful field of tax regulation.

Controlling the general economic system

Best known of proposals to remold the economic system by taxation is the so-called Single Tax. Formulated by Henry George in his *Progress and Poverty*, published in 1879, the Single Tax was to be a tax on the economic rent of land—the annual yield of its natural fertility or location value as distinguished from the return from labor bestowed upon or capital invested upon the land. For moral justification of such a tax, George pointed out that economic rent was an unearned increment to the recipient, a return that came to him from mere appropriation and ownership without his having performed any service therefor. The economic effect would be to discourage speculative holding of land for a higher price, since with all economic rent continuously expropriated by the State, there could be no rise in land value except from labor and capital invested in it. Such elimination of speculative holding of land would cause it to be rapidly developed, and so contribute to the nation's economic growth and prosperity.

During the 1930's a number of suggestions for "taxing the country out of depression" were advanced and one was enacted. They all rested on the premise that when purchasing power is saved, and these savings instead of being translated soon into investment are "hoarded" in cash form or unused deposits, the economic mechanism of the country bogs down. One, the proposed currency-and-deposits tax already mentioned,¹⁷ would have imposed a heavy penalty tax on cash holdings and bank deposits, to force these sums into either expenditure or investment. A second idea, Hazelett's widely publicized "incentive tax,"¹⁸ was a 30 per cent federal corporation income tax with the rate reduced 2 per cent per annual turnover of a corporation's average monthly cash balance—an indirect way of taxing "hoarded" corporate balances. The undistributed profits tax, enacted in 1936, was in a way a third approach to the same idea, since corporate earnings forced into stockholders' hands by dividend declarations were far more likely to be spent than if the corporations retained them.

Conclusion

Most fiscal scholars condemn regulatory taxation as perverting the true purpose of taxation—revenue. Regulatory intent, they say, interferes with the conformity of taxes to the principles of fiscal justice. And finally, the regulation of the economic system or any phase of it through taxation demands a degree of wisdom which neither lawmakers nor tax administrators possess.

Such blanket condemnation of regulatory taxation, though backed by eminent authorities, rests on weak logical grounds. Although revenue is unquestionably the primary purpose of most taxes, to state that it is the one and only "true" purpose of taxation is mere arbitrary assertion. Fiscal justice is in many cases not affronted by regulatory taxes since if they are successes as regulatory measures, they will yield little or no revenue, and hence work little or no fiscal injustice. And economic regulation, if it is to be undertaken, requires

¹⁷ See pp. 270-271 of this volume.

¹⁸ C. William Hazelett, *Incentive Taxation* (Dutton & Co., New York, 1936); and the same author's "Incentive Taxation," *Taxes*, January 1941, pp. 24-28.

for its accomplishment by taxation no greater legislative or administrative wisdom than the use of more direct means. Furthermore, as a recent study indicates,

The taxing power can be easily demonstrated to have many advantages over "ordering and forbidding devices" that are conventionally employed by the police state. It does not ordinarily imply a vast bureaucracy, it leaves the specific decisions in the hands of private entrepreneurs; it is largely automatic and immediately effective. Its sanctions strike at the very sinews of economic power—the payment of money. The taxing power, however, is of course neither the exclusive technique available to the modern state, nor one suitable for all ends of policy, but it is one that must be skillfully blended with all the other powers and instrumentalities of government in effectuating common objectives.¹⁹

A regulatory tax is but a means to an end, and it must be judged by that end. If a practice universally acknowledged to be bad, such as the sale of narcotics, cannot be stopped by direct prohibition because of constitutional limitations on the federal government but can be checked by a tax, what reasonable objection can be raised against such a tax? If educational and charitable institutions can be stimulated by tax exemption, why not exempt them? Where the objective is a special group disadvantage won at the expense of the general welfare, as in the case of oleomargarine and chain-store taxes, then the taxes that accomplish such an end are to be condemned, just as any more direct means to accomplish such a purpose would have to be condemned. And where there is dispute as to the goal, as with control of holding companies or regulation of saving, any tax measures directed toward such goals are open to debate. In all cases, however, it is not the tax measure as such that invites criticism, but its ultimate purpose.

¹⁹ Temporary National Economic Committee, *Taxation of Corporate Enterprise* (Monograph No. 9, Washington, 1941), p. 115.

CHAPTER XII

Distributive Aspects of Taxation

UNDER a general poll tax, every individual would pay the same tax. Any other system of taxation requires some individuals to pay, directly or indirectly, heavier taxes than others. Distribution of the burden among individuals and social and economic classes is determined by the character of the tax system. Are there any ultimate principles for such distribution of tax burdens whereby different tax systems can be approved or condemned? In other words, what, if any, are the principles of "justice" in taxation?

Most discussions of tax distribution principles are *ex parte* denunciations or defenses of particular taxes. The resultant conclusions are of little value to students of tax theory, since all such writings involve at their very inception a misunderstanding of the place of tax distribution principles in fiscal theory. These principles have no application to particular taxes; they can be applied only to systems of taxes. A general sales tax, standing by itself, might be difficult to justify. But a moderate sales tax could work in very acceptably with a progressive income tax embodying a large minimum exemption. It should never be forgotten that the distributional effect of any one tax may be counterpoised by other taxes in the system. Individual taxes may be praised or condemned for their effect on the distribution of the burden of a tax system, but never for the distribution of their own exclusive burden.

DISTRIBUTION OF TAX BURDENS AMONG INDIVIDUALS

Five major doctrines have been propounded upon the distribution of tax burdens among individuals: (1) the benefit doctrine, (2) the privilege doctrine, (3) the State-partnership doctrine, (4) the objective ability doctrine, and (5) the subjective sacrifice doctrine.

Benefit doctrines

The principle of the benefit doctrine of tax distribution is concise: each individual should be taxed in proportion to the benefits he derives from governmental functions. The doctrine has two branches: (1) the cost-of-service theory, and (2) the value-of-service theory.

Underlying the cost-of-service theory is the thought that each individual should be compelled by taxation to pay the cost of the services performed for him by the government. Governmental functions would be conducted on the principle of government enterprises; through taxes, each individual would be assessed the cost of the services performed for him by the government. But none of the champions of the cost-of-service theory ever suggested a basis for apportioning governmental costs among the individuals benefited. A moment's thought will indicate that no such basis is possible except for government enterprise services and a few occupational control functions financed by license charges. How can your individual responsibility and my individual responsibility for the cost of the federal government's 1941 defense effort be determined? How can responsibility for the costs of a child's education be allocated to the child itself who may not want to attend school, to its parents who may or may not wish their offspring educated, to his future employers who want a trained employee, to the general community which is better off for an educated populace, and to all the others who have an interest in the promotion of popular education? Any attempt to translate the cost-of-service theory into specific terms reduces it to nonsense.

According to the value-of-service theory, an individual should share in the total costs of government in proportion to the value of the benefits he derives. Here, too, there is the difficulty of measuring the extent to which each person benefits from governmental activities. Value-of-service doctrine advocates have, however, proposed various standards for measuring the benefit of governmental activities to individuals. Those who conceive protection to be the sole function of government have argued that the individual benefit

from protection varies in proportion to the property owned. To such writers, a single general property tax has seemed the best means of distributing tax burdens equitably¹—it is a sort of insurance premium.² Other writers have contended that since each individual benefits from governmental activities to the extent that he eats, drinks, and otherwise enjoys life in a material manner, a tax based on private expenditure, a retail sales tax, would be most just.³

Quid pro quo doctrines of tax distribution were natural as long as national and domestic protection was the major function of government. It could reasonably be argued that protection thus bore some relation to property or expenditures, even though now we look upon any individual benefit from protective function as an incidental by-product of the more important indivisible social benefit inherent in it.⁴ Today general public welfare is the major objective of many governmental activities, and any individual benefits are recognized as purely incidental. Education and social welfare are examples of such activities. An individual taxpayer, as such, rarely derives any direct, personal benefit from such activities; the social group, as a group, is the beneficiary. Benefit doctrines of tax distribution can no longer find general application because of the subordination of individual benefit in many of the present governmental functions.

As is indicated in a later chapter,⁵ the benefit principle still finds application in fees, license fees, and special assessments. Furthermore, it still finds a limited application in the field of taxation. Occasionally, it is possible to isolate a class of individuals or of property, marked by some distinguishing characteristic, which derives a special benefit from some broad group of governmental activities. Special taxes levied on such a class are justified by the special benefits bestowed upon it by the government. Motorists, distinguished from other individuals by their ownership of motor cars and consumption of motor fuels, derive a special benefit from governmental expend-

¹ J. H. G. von Justi, *Staatswirtschaft* (second edition, 1758), Part II, sec. 228, p. 312.

² A. Thiers, *De la propriété* (1848), p. 352.

³ W. Petty, *A Treatise of Taxes and Contributions* (1667), p. 72. This was the general viewpoint of the school of "natural rights" philosophers.

⁴ See p. 34 of this volume.

⁵ See pp. 608, 610, and 614 of this volume.

itures on highway construction and maintenance. Two "benefit" taxes can, therefore, be imposed upon them—the motor vehicle license tax and the motor fuel tax. Heavy trucks contribute more than light trucks to highway wear and tear and they can, therefore, be compelled to pay more. Common carrier motor vehicles owe their possibility of profit to state highway construction and maintenance, and they can be taxed more heavily than other cars since their benefit is relatively greater. So also, in a broad way, many government activities may be said to be of special benefit to business enterprise rather than of general benefit to individuals as such. On this argument, general business taxes have a "benefit" justification in addition to their other distributive justifications.

Privilege doctrine

A special variant of the benefit doctrines goes under the name of the "privilege" theory. Its substance is that the legal privileges granted by governments—the privilege of inheriting property, or the privilege of doing business as a corporation, for example—confer special benefits that could not be enjoyed except for the government's grant of *permission*, and that these special benefits warrant special taxes. Many yardsticks, among them property used in connection with the privilege or net or gross income resulting from its exercise, may be used to measure the benefits presumably derived from the exercise of the privilege. The privilege and value-of-service doctrines are thus somewhat analogous, except that the taxpayer's special benefit is presumed to derive not from any government activity or service, but from the permission to do something not otherwise legally permissible.

Isolating the group benefiting from a legal privilege in order to impose a special tax upon it involves little administrative difficulty. If the privilege consists of doing an act which would otherwise be without legal sanction, the tax can be levied on each performance of the act, as with death taxes levied on property passing by bequest or inheritance. If the privilege is one of assuming a condition not otherwise permissible, as in doing business in a corporate form, the tax can be imposed on the occasion of each renewal of the privilege.

Basic weakness of the privilege doctrine is its underlying assumption that the permission to perform certain acts or assume certain conditions confers a special benefit. Actually, the State is all-sovereign, and except for self-imposed constitutional limitations, has the power to prohibit every act and every condition. From this point of view, every act or condition not specifically prohibited might be considered specially permitted. To do business in an unincorporated form is as much a legal privilege as to do business in an incorporated form. To dispose of property by gift or sale is as much subject to government permission as to dispose of it by inheritance or bequest. When every act and every condition may be considered the exercise of a legal privilege, what special economic benefit is inherent in any particular legal privilege to justify its being made the basis of a special tax?

State-partnership doctrines

Still another variant of the benefit theory—the State-partnership doctrine—is sometimes offered as special justification for business and land increment taxes. In support of business taxes, it may be argued that business can be transacted in security and safety only because of the protection accorded by the State. Furthermore, the State provides and enforces laws such as the Uniform Sales Law and the Negotiable Instruments Law, which facilitate business intercourse. And various governmental departments collect and disseminate information of particular value to business firms. The State, therefore, is an active partner in every profit-making business enterprise, and should receive its partnership share in the profits. This share may be taken in the form of special business taxes, preferably net income taxes.

Henry George and other proponents of land increment taxation argued that society achieves economic advancement, communities grow in size, and land becomes increasingly valuable only by reason of the protective presence of stable governments. Governments being silent partners in bringing about increases in land values, they should receive a due share of such profits by special increment taxes.

Unless some sort of single tax is proposed—a single business tax, or

a single increment tax—the State-partnership doctrine provides no general standard of tax distribution. Moreover, the idea of partnership between the government and individuals is an analogy, an argumentative fiction, rather than a sound deductive premise. At most, the State-partnership doctrine can be but a supplementary argument buttressing a tax which finds its major justification under some other doctrine. By itself, the theory would be tenuous support for the imposition of any particular tax.⁶

Objective ability doctrines

Behind the “ability” doctrine of taxation is the principle that government costs are incurred for general social purposes, and are an obligation of society rather than of particular individuals. This obligation must be distributed among the individuals composing the social unit in a manner which imposes the least hardship. And the least hardship results when each individual contributes pro rata to his “ability” or “faculty.” Adam Smith made the ability doctrine the first of his four canons of taxation:

I. The subjects of every state ought to contribute toward the support of the government, as nearly as possible in proportion to their respective abilities; that is, in proportion to the revenue which they respectively enjoy under the protection of the state.⁷

Today it is generally accepted as a proper standard of tax distribution. ✓

Most fiscal writers hold that the “ability” concept can be applied properly only to individuals, that a business enterprise or corporation has no independent, impersonal “tax-paying ability.”⁸ But in recent years the argument has been developed that business units possess an impersonal tax “ability” measured by net income and by the relation of net income to capital; this argument is used to justify

⁶ For disapproval of this curt dismissal of the State-partnership doctrine, and a positive argument for the theory, see Paul Studensky, “Toward a Theory of Business Taxation,” in *Journal of Political Economy*, Vol. XLVIII, October 1940, pp. 630-631.

⁷ Adam Smith, *The Wealth of Nations*, Book V, Ch. 2.

⁸ See Carl Shoup, “Business Taxes,” in *Encyclopaedia of the Social Sciences* (New York, 1934), Vol. III, p. 123.

proportional corporation income tax and progressive excess profits taxes.⁹

"Ability" is a vague term and has been given many interpretations. Colonial America held the individual to be the norm of "ability," and on this standard, a poll tax was considered essentially equitable. Jean Bodin and many later writers considered property the best criterion of taxpaying "ability." Property yields, individual expenditures, individual incomes, and savings have at various times been proposed as ideal criteria of "ability." Income is popularly accepted today as the standard of "ability."

Each of the proposed objective measures of "ability," including the income standard, suffers from the same shortcoming—it fails actually to measure "ability." If one individual has twice as much property, or in the course of a year, spends twice as much, or receives twice as much income, or saves twice as much as a second individual, does the first individual have exactly twice as much "ability" as the second individual, or is the proportion somewhat more than double, or somewhat less than double? None of the objective "ability" doctrines can answer these questions. Whether the tax burden should be proportional, regressive, or progressive in relation to property, expenditure, savings, or income, remains an open issue.¹⁰

Subjective sacrifice doctrines

John Stuart Mill¹¹ first propounded the subjective sacrifice doctrine, a refinement upon the objective ability doctrine of tax distribution. That income, property, savings, or any other measuring rod of taxpaying "ability," has a diminishing utility to its possessor, is a basic proposition. Consequently, a rich man's payment of a given sum in taxes entails less sacrifice than the poor man's payment of an equal amount. Some writers argue in conclusion that the tax legislator's ideal should be "equal" sacrifice on all taxpayers. A second group of writers argues for "proportional" sacrifice. Still a third

⁹ Studensky, *loc cit*, pp. 632-639

¹⁰ Cf. M. Slade Kendrick, "The Ability-to-Pay Theory of Taxation," *American Economic Review*, Vol. XXIX, March 1939, pp. 92-101

¹¹ John Stuart Mill, *Political Economy* (London, 1848), Book V, Ch. 2, sec. 2

school of economists insists upon "minimum or least social sacrifice" as the ideal.

But if any subjective sacrifice theory—the "equal" sacrifice principle, the "proportional" sacrifice principle, or the "least" sacrifice principle—is to provide a clear standard for tax burden distribution, the exact formula for the diminishing utility of wealth or income must be known. And as yet, the "law" of the diminishing utility of wealth or income has not been inductively established.¹² Every fiscal economist being free to choose his own formula, agreement among them is rare. According to the particular formula of diminishing utility chosen, the "equal" sacrifice principle can lead to regressive, proportional, or progressive taxation, "proportional" sacrifice may produce proportional or progressive taxation, and progressive taxation or outright confiscation of all wealth or income above a given figure may be the outcome of the "least" sacrifice principle.

Critique

Every doctrine of "tax justice" we have analyzed is based on an arbitrary assumption—taxes should be "just." Yet this is hardly a tested scientific principle. Even at best it merely expresses a pious hope. But since both taxpayers and legislators maintain that taxes should be "just," this principle has pragmatic sanction as a basis for constructing tax systems—or rather, it would have such sanction if it could be utilized.

But the factors of tax justice posited—benefit, ability, and sacrifice—are also arbitrary assumptions. Arguments for and against each factor can be built up with equal facility. And there is no unanimous popular acceptance of one factor to the exclusion of others. The "man in the street" will agree readily that taxes should be levied according to benefits received, and also according to the taxpayer's ability, and also according to sacrifices imposed—though widely different conclusions may be drawn from each of these first premises

Still a third set of arbitrary assertions enter—the measures of bene-

¹² See Elmer D. Fagan, "Recent and Contemporary Theories of Progressive Taxation," *Journal of Political Economy*, Vol. XLVI, August 1938, pp. 458-485.

fit, or ability, or sacrifice. Is wealth the best measure of benefit, or ability, or sacrifice? Or is income the best measure? Or consumption expenditure? Or savings? Or some other element?

As matters stand, if the right combination of factor and measure is used in building up the argument, any tax system can be proved the epitome of "justice." By using a different combination of factor and measure, however, the same tax system can be proved utterly unjust. The situation would be ludicrous—a good joke on the fiscal scholars, if popular aspiration for "justice in taxation" did not play into the hands of self-seeking interests and their propagandists. Lobbyists for independent retailers argue that chain stores have special elements of "ability" which warrant their being subjected to prohibitive chain-store taxes. Railroads would like to see their bus line and trucking company competitors hampered by higher taxes, and argue, under the "cost-of-service" doctrine, that highway users should bear the total cost of highway construction and maintenance. Representatives of truckers' and automobile owners' associations oppose increased highway taxes by appeal to "value-of-service" and "ability" doctrines. With the various group interests seeking to shift tax burdens onto "the other fellow," "justice" and "injustice" have become mumbo-jumbo words to conjure support or provoke opposition from a blind and bewildered public opinion.

DISTRIBUTION OF TAX BURDENS AMONG ECONOMIC AND SOCIAL CLASSES

Classical fiscal theory was concerned solely with the distribution of tax burdens among individuals. Neither lawmakers nor economists had to concern themselves with the resultant distribution of these burdens among social and economic classes—whether a tax or a tax system tended to make the rich richer and the poor poorer, or contrariwise.

Outside of Classical tradition, however, various writers have studied the social incidence of tax systems. Progressive rate schedules in personal income and inheritance taxes, nonshiftable business taxes, and high personal exemptions were noted as throwing the burden of a tax system on the richer elements of a population. Taxes

on commodities and dwellings, it was seen, were paid largely by the poorer classes.

Since taxes and tax systems do discriminate between social classes, should this discrimination be permitted to motivate the framing of tax systems—should a tax be levied for its “social regulatory” effects? Should the State use its taxing power to eliminate or reduce inequalities of wealth and income? A scattered line of scholars outside Classical tradition have answered “yes.” In the fifteenth century the Florentine scholar Guicciardini wrote:

Since we are all citizens of the same state and each the equal of the other, there can be no true equality or justice in taxation unless the taxes reduce us all to the same economic level. . . . If, then, we introduce the progressive principle (with sufficient severity) we shall become truly equal as we reasonably ought to be.¹³

Adolph Wagner, the German economist, gave this “socio-political theory of taxation” more precise expression in the nineteenth century:

Taxation, in addition to serving the purely financial purpose of providing sufficient revenue, should be employed for the purpose of bringing about a different distribution of wealth from that which would result from the working of free competition upon the basis of the present social order.¹⁴

This idea of utilizing taxation as an instrument of social equalization is, with increasing frequency, forcing itself into current tax literature and—as evidenced by the growing use of the phrase “Soak the rich”—into tax practice.

“Equalization” doctrines, as may be seen in the Guicciardini quotation, frequently seek to ally themselves with one or another of the

¹³ Quoted in Edwin R. A. Seligman, *Progressive Taxation in Theory and Practice* (second edition, American Economic Association, 1908), p. 135.

¹⁴ Adolf Wagner, *Finanzwissenschaft* (Leipzig, 1880), Vol. I, § 27, quoted in Charles J. Bullock, *Selected Readings in Public Finance* (Ginn & Co., Boston, second edition 1920), p. 255, and in Elmer D. Fagan and C. W. Mac., *Public Finance* (Longmans, Green & Co., New York, 1934), p. 179.

"justice" principles already analyzed—some modern writers carefully avoid the damning term "equalization" and present the principle under the name of "social justice." Fundamentally, there can be no alliance between principles of "justice" in the distribution of individual tax burdens, and the doctrine of utilizing the tax power to achieve extrinsic social aims. The lines of argument run in different planes, and can never fuse.

Tax power, under the "equalization" doctrine, becomes a weapon in class struggle. And the class struggles are many—between the farmer and the rest of the community, between the manufacturer and other group interests, between the land owner and other elements in economic society, as well as the one between rich and poor. Shall taxes be levied and tax systems framed to relieve one class of tax burden and impose a corresponding extra burden on the remainder? There have been more than a few affirmatives. Champions of the farmers point to their continuous depression of nearly two decades, and insist that shifting tax burdens to other groups would help "equalize" this condition. Real estate interests proclaim the "equalization" doctrine in support of property tax limitation laws

To state that a tax system should have a social or class aim is, like the statement that it should be "just," an arbitrary assertion beyond the scope of proof or disproof. And to deny that a tax may have such an aim is alike arbitrary. The scholar can neither approve nor condemn the "equalization" doctrine. He can but record its prevalence and the extent to which it influences tax legislation. As motivation for tax legislation in the United States, "equalization" ideas have assumed increasing importance. "Soaking the rich" has advanced from the stage of fiscal heresy to that of popular tolerance, if not acceptance.

TAX EXEMPTIONS

Tax exemptions may be grouped into five classes, according to the motivations behind them:¹⁵

¹⁵ Cf. James W. Martin, "General Theory of Tax Exemption," in *Tax Policy League, Tax Exemptions* (the League, New York, 1939), pp. 5-6.

- (1) Constitutional exemptions, necessitated by the federal and state constitutional limitations on tax legislation
- (2) Economic exemptions, like those to encourage the settlement or development of new enterprises
- (3) Distributive exemptions in the interests of "tax justice"—minimum personal exemptions, and exemptions to eliminate overlapping double taxation
- (4) Exemptions to accomplish social ends
- (5) Administrative exemptions

The first class of exemptions was considered in Chapters VIII and IX, the second class will be covered in Chapter XV. Administrative exemptions are discussed in Chapter XIII. Here we shall consider minimum and social exemptions motivated by distributional considerations.

Minimum exemptions

In taxes levied on individuals, minimum exemptions are unanimously deemed desirable. Underlying this feeling is the realization that the extremely poor pay taxes not merely at the cost of some luxuries or savings, but at the cost of the necessities of life.

Classical economists would have limited minimum tax exemptions to a "minimum-of-subsistence" level. They approved only those exemptions covering the lowest income which would keep the recipients alive and in strength. Were basic subsistence taxed, they argued, the sickness and death resulting from the diminished incomes of the poor would, by reducing the working population, force wages up and shift the tax to employers. At the present time and in this country, the view taken is broader. A moderate standard of living rather than the minimum of subsistence should be the measure for tax exemptions. The feeling now is that the socially desirable standard of living is one which includes moderate comforts for even the poorest classes. Individuals who just manage to achieve this moderate standard should not have their circumstances straitened by the imposition of a tax. Such individuals, argue proponents of the ability and sacrifice doctrines of taxation, are without "taxpaying ability." And finally, a considerable burden of commodity,

business, and property taxes is shifted into consumption expenditure, where it bears especially heavily on the lowest income groups; substantial minimum exemptions in personal taxes counterbalance to some extent this maldistribution of tax burdens.

A moderate minimum exemption greatly simplifies the administration of many taxes. Since costs of assessment and collection for a tax on incomes or estates of a few hundred dollars would often be greater than the revenue collected, common sense dictates their exemption. Exemptions advisable for administrative reasons are, in general, higher than those approved on distributive grounds. The administrative argument for exemptions is best viewed as a supplement to the distributional argument.

Minimum exemptions take three forms: (1) lump-sum, (2) continuing, and (3) vanishing. Under a lump-sum exemption, should the income, estate, or other taxable element exceed the exempted amount even by a small sum, the entire amount is subject to the tax. If an income tax exemption is fixed at \$2000, a \$1999 income would be tax free while a \$2001 income would be entirely taxable. This form of exemption is obviously unjust, and is rarely found.

Continuing exemptions allow the full amount of exemption regardless of the size of the income, estate, or other taxable element. If the \$2000 income tax exemption is continuing, a \$50,000,000 income as well as one of \$2500 would be permitted the full exemption. Allowing minimum exemptions to large taxpayers is no part of the principle of minimum exemptions, and reduces the tax yield for no good purpose. Despite this disadvantage, however, the continuing exemption is the characteristic form of minimum exemption in American taxes.

"Vanishing" exemptions, the third form of minimum exemptions, avoid the disadvantages of both the lump-sum and the continuing exemptions. With this form, the exemption diminishes as the tax base increases over the exemption figure. In an income tax with a \$2000 exemption vanishing at a dollar-for-dollar rate, a \$2000 income would be entirely exempt, one of \$3000 would enjoy a \$1000 exemption, while an income of \$4000 would be fully taxable. Unlike the

lump-sum exemption, the "vanishing" exemption does not involve a sudden, heavy tax imposition. Moreover, it grants no exemption to rich individuals who do not need it and for whom it was not intended.

Social exemptions

State and local property taxes commonly exempt the property of religious, charitable, educational, and similar institutions. So also, incorporated institutions of this character are free from special corporation taxes. Bequests and gifts to such institutions are generally exempted from death and income taxation.

Several reasons justify these social exemptions. Since most of these institutions do not earn any true profit, they are, on this score, without taxpaying ability. Then, too, their services are of great social value to the community, and to compel them to curtail these services for the sake of a small amount of tax revenue would be unreasonable. Furthermore, it is frequently argued, these institutions perform services which state or local governments would otherwise have to undertake. Compel them by taxation to forego such performance, and the government would be putting money into one pocket by taking it out of the other.

But the policy of liberal social exemptions has not altogether escaped criticism. In some quarters the objection raised is that an exemption of religious property is in effect a subsidy to churches— forbidden by many state constitutions. Exemption of profit-producing property owned by religious, charitable, and educational institutions has also been protested. While the profit derived from such property may be utilized for social ends, the property itself is employed as an economic asset and should contribute its quota to the upkeep of the governments which make its economic use possible. And not infrequently, a large educational or religious institution engrosses so great a proportion of the property in a small taxing district that a disproportionate burden is imposed on the remaining property.

PROGRESSIVE TAXATION

We noted earlier in this chapter that choice of a principle of tax justice—benefit, or ability, or sacrifice—and selection of a measure of that principle—property, or income, or expenditure, or savings, or some other element—leaves still unsettled the question of how this measure should be employed in framing a schedule of tax rates. Should the tax be proportional—should it constitute a fixed proportion of the taxpayer's property, income, expenditure, or savings? Should the tax be progressive, with successively higher rates on larger units of the measure? Should the tax be regressive, with rates decreasing for successively larger units of the measure? And if the tax is to be either progressive or regressive, what should be the formula?

Theory

Nineteenth-century proponents of the benefit doctrine of taxation usually argued for either the regressive or proportional distribution of the general burden. The argument for regression was based upon the observations that a government's social expenditures benefited the poorer more than the richer classes, and that governmental protection was much more the prevention of exploitation of the poorer by the richer classes, than vice versa. Proportional distribution of tax burdens was defended upon the generalization that the protective activities of government concerned property rather than individuals, and hence a tax burden proportional to individual property holdings paralleled the distribution of governmental benefits. A few writers, however, argued that the benefit principle of taxation dictated a progressive tax burden. Governmental expenditures, they said, went largely to protect the property and persons of the rich from attack by the poor, and many governmental expenditures were of particular benefit to the rich.

During the nineteenth century, a French radical¹⁶ and a conservative American economist¹⁷ advanced the "compensatory" argument

¹⁶ C. A. Royer, *Théorie de l'impôt ou la dîme sociale* (Paris, 1862)

¹⁷ Francis A. Walker, *Political Economy* (New York, 1883), pp. 489-490. Note that in the 1888 third edition of this work, these passages were omitted.

for progression. This argument, although it is somewhat allied to the benefit argument for progression, clearly results from an independent line of thinking. Francis Walker's justifications for progressive taxation were: (1) "the undoubted fact that differences of property and income are due, in no small degree, to the failure of the state in its duty of protecting men against violence and fraud," and (2) "differences in wealth are in a measure due to the acts of the state itself, having no political purpose, as treaties of commerce, tariffs, currency legislation, embargoes, non-intercourse acts, wars, etc."

But the ability and sacrifice doctrines of tax distribution present the strongest arguments for progression. According to many adherents of the ability principle, since the principle of diminishing utility applies to ownership of wealth and receipt of income, taxpaying ability increases more rapidly than does the increase of wealth or income. A poor man's property holdings represent necessities or seminecessities, and all his income is expended on such items. As wealth and income increase, the proportions devoted to necessities and seminecessities grow smaller and smaller. And the surplus over and above the possession and purchase of necessities and seminecessities, which measures taxpaying ability most truly, mounts more rapidly than the basic wealth or income. Sacrifice doctrines of tax distribution, which are essentially psychological statements of the ability doctrine, can be similarly argued to support progression.¹⁸

Progressive taxation is, of course, the keystone of the equalization doctrines of taxation. But the literal acceptance of these doctrines would lead to a progression so steep as to be confiscatory on large fortunes and incomes.

Distributive arguments for progressive taxation suffer from the general weakness which afflicts all the doctrines of tax distribution. As previously indicated, these doctrines rest on bald, unproven, and

¹⁸ It is interesting to note that the "sacrifice" argument for progressive taxation was compactly stated in the *Institutes of Manu*, supposed to date from the twelfth century B.C.

"To make the burden of taxes equal, it should be made to press with equal severity upon every individual. This is not effected by a mere numerical proportion. The man who is taxed to the amount of one-tenth of an income of 100 rupees per annum, is taxed far more severely than the man who is taxed an equal proportion of an income of 1000 rupees."

unprovable assumptions concerning social psychology and the relationship between governments and individuals. Conflicting first premises lead to conflicting conclusions. Every distributive argument to sustain the principle of tax progression is matched by another sustaining regressive or proportional taxation. More to the point is the pragmatic consideration that proportional and progressive taxation work no palpable injustice, while regressive taxation directly affronts common-sense standards of fiscal justice.

Accomplishment of tax progression

A progressive tax burden, it is frequently stated, can be established only by personal taxes having progressive rate schedules. Besides this obvious method, however, an element of tax progression can be secured by a judicious selection of nonpersonal taxes, and by the use of continuing exemptions.

Commodity taxes are generally shifted to the purchasers. If, therefore, commodities purchased exclusively by the wealthy are subjected to special taxes, to the extent that these taxes are shifted, they will impose a special burden on the wealthier classes. During World War I and the postwar years the federal government and many European governments imposed special luxury taxes, partly to discourage temporarily the production and consumption of such luxuries, but partly, also, to draw revenues from the wealthier classes without imposing additional burdens on the poorer classes.

Since ownership of business, particularly of large-scale enterprise, is naturally concentrated in the wealthier classes, nonshiftable business taxes which reduce business profits rest more heavily on the rich than on the poor. Consequently, a corporation income tax with a proportional rate imposes a crudely progressive burden upon individual incomes.

How a continuing exemption in a tax with a proportional rate can produce progression, is illustrated by the accompanying hypothetical example of a five per cent income tax with a \$2000 exemption. As the taxable base—income for example—increases above the exemption figure, the amount exempted is an ever-smaller fraction of the whole, and the tax rate applies to a growing proportion of the

whole. With a small exemption and a low tax rate, the resulting progression is inconsiderable. A combined large exemption and high tax rate might, however, produce a relatively steep progression.

| Total Income | Taxable Income | Tax | Tax as Percent of Total Income |
|--------------|----------------|------|--------------------------------|
| \$2,000 | \$ 0 | \$ 0 | 0 |
| 2,500 | 500 | 25 | 1 0 |
| 3,000 | 1,000 | 50 | 1 7 |
| 3,500 | 1,500 | 75 | 2 1 |
| 4,000 | 2,000 | 100 | 2 5 |
| 4,500 | 2,500 | 125 | 2 8 |
| 5,000 | 3,000 | 150 | 3 0 |
| | etc | | |

Progressive rate schedules

Progression can be introduced into a tax system by the levy of personal taxes—income and death taxes and, under limited circumstances, property taxes—having progressive rate schedules. But progression applied to the rate schedules of commodity taxes cannot hope to accomplish progression in the ultimate tax burden, since in shifting, the relation of the tax burden to the original tax base is changed. Nor will a progressive rate schedule in a business tax produce a progressive tax burden upon any group of individuals. All relation between burden and base disappears if the tax is shifted. And in the case of a nonshifted business tax, there is no assurance of any consistent relationship between the business base involved and the private circumstances of the owners of the taxed business. Progressive business taxes may accomplish various regulatory ends, but they are a mistaken means to any distributive end.

Personal tax schedules can be made progressive in three ways. Instead of stating the tax as a percentage rate, it can be stated in fixed amounts per unit of the base. An income tax might thus be levied \$1 for incomes up to \$100, \$3 for incomes between \$100 and \$200, \$6 for incomes between \$200 and \$300, and so forth. This method of levying a progressive tax is not only cumbersome but involves regres-

sion within the limits of each tax bracket. Progressive personal taxes in the United States are not levied in this manner.

Where the rate of a personal tax is stated as a percentage, its progression may be either lump-sum or by brackets. Lump-sum progression is accomplished by applying each successively higher rate to the entire tax base. In an income tax, incomes up to \$1000 might be taxed one per cent, incomes between \$1000 and \$2000 might be taxed two per cent on the entire income, incomes between \$2000 and \$3000 might be taxed three per cent on the entire income, and so forth. For bracket progression, each successively higher rate is applied only to that portion of the income coming within the tax bracket. Thus the income tax might be one per cent on incomes up to \$1000, one per cent on the first \$1000 of incomes between \$1000 and \$2000 and two per cent on the excess, while incomes between \$2000 and \$3000 might be taxed one per cent on the first \$1000, two per cent on the next \$1000, and three per cent on the excess of the income over \$2000. With rate schedules otherwise comparable, lump-sum progression imposes the heavier burden, because the high rates apply to the whole rather than to a fraction of large incomes or estates. Neither form of progression is inherently objectionable. In the United States, bracket progression is the more popular.

There is no standard to determine the proper or best degree of progression for personal taxes—it is a matter of legislative discretion. Progression in federal personal taxes is vaguely limited by the evasion and avoidance induced by excessively high upper-bracket rates. Progression in state taxes is more definitely limited. Should rates on large incomes or estates be too heavy in one state, the recipients or owners will change their residences to another state more modest in its demands.

CHAPTER XIII

Fiscal and Administrative Considerations

FASCINATED by the sinuosities of legal reasoning upon taxation, by the complexities of tax economics, and by the engaging sophistry of distributive argument, the student of taxation is sometimes inclined to overlook the primary purpose of most tax statutes—to produce revenue. But the best possible tax by legal, economic, and distributive standards—if there were such a tax—would have no place on the statute books if it yielded no revenue. And many a tax subjected to the tax scholars' barrages of criticism is levied and collected year after year because it pours a steady stream of dollars into local, or state, or federal treasuries

FISCAL CONSIDERATIONS

Revenue yield is determined partly by the inherent character of a tax, partly by extrinsic circumstances.

Inherent productivity

Some taxes produce billions of dollars of revenue a year, others only a few thousands. These differences in productivity depend primarily on the tax base, and secondarily on the rate schedule, the related economic effects of the tax, and its administrative aspects.

As an obvious generalization, we may say that the broader the base of a tax, the greater its revenue possibilities. With property values in the United States measured by the hundreds of billions of dollars, a general property tax even at moderate rates is certain to produce tremendous revenues. So, too, with a gross income or general sales tax and, to a lesser extent, with a general net income tax. A tobacco products or gasoline tax, involving an item of general consumption, can likewise produce hundreds of millions of revenue in the United States. But a tax on a comparatively narrow base can yield only a

trifle. A federal tax on club dues or yacht sales can produce only a few million or a few thousand dollars revenue.

Any exemption which narrows the tax base naturally reduces productivity. Personal exemptions in the federal income tax slice a substantial fraction from gross yield, though the net reduction is probably relatively moderate, since a big saving is effected in administration costs. An even greater loss of productivity results from the \$40,000 federal estate duty exemption. From one-fifth to one-third of retail sales tax revenue is sacrificed by exempting foodstuffs.

Within limits, the higher the tax rate, the greater its yield. But taxes are sharply subject to the rule of diminishing productivity. Each tax rate increase is likely to produce less of an increase in yield than the preceding corresponding rate increase. Particularly is this true of business and personal taxes, where incentives to avoidance and evasion multiply as the tax rate increases. If personal income or business tax rates are pushed high enough, avoidance and evasion will actually reduce the yield. Optimum rates for state income and business taxes are surprisingly low, because escape—by removal into other lower-taxing states—is always open to some taxpayers.

A tax on a commodity having highly elastic demand is likely to fail as a revenue producer because of the consequent related decline of consumption and production. So, too, a tax on one of two competing commodities or lines of business, by causing consumption demand to shift to the untaxed commodity or business, leaves a narrow base for the tax.

Finally, taxes differ widely in the acuteness of their administrative problems. A stamp tax on legal documents is practically self-administering, while no amount of efficient organization or technical adroitness has succeeded in assessing a property tax on intangible personalty. Evasion, the sign of administrative failure, can curtail tax productivity as effectively as any of the factors previously considered.

Stability

In the course of the business cycle, the yield of a tax based upon net income fluctuates widely. A given rate schedule may produce

tremendous revenues in boom years and a bare dribble in depression periods. Revenues from taxes based on property values, on gross income, or on sales are much more stable. They rise and fall with the flow and ebb of the business cycle, but far more moderately than net income tax revenues. And some taxes—the poll tax, for example—are practically unaffected by cyclical business developments.

Stability is a desirable element in the revenue system of any government, unless there is a definite intention to palliate depression by operating on a “cyclical budget,” with deficit financing during the depression years. Consistent revenue inflow is essential to effective budgeting. And any government is in desperate plight if its income falls sharply off in depression time, when it is called upon to make extra expenditures for relief. Desirable though net income taxes may be from many angles, unless a government is willing and able to take the risk of wide income fluctuation, it may not build its revenue system exclusively, or even preponderantly, around such taxes. A number of state governments, in order to establish minimum tax liability,¹ buttress their corporation income taxes by alternative capital stock or gross income schedules.

Elasticity

Elasticity in response to budgetary requirement must be combined with the stability of a revenue system in relation to extrinsic circumstances. Emergencies or an enlarged scope of governmental activity may necessitate more revenue than is yielded by the current tax system. Or, more rarely, a reduction of governmental expenditures may pave the way for a reduction of revenues.

Rate variation can make the yield of most nonregulatory taxes elastic. Raise the rates, and the yield will be higher. Lower the rates, and the yield will be reduced. But not proportionately. The principle of diminishing productivity, propounded earlier in this chapter, is a factor that must be taken into account. As the rate or rate schedule of any tax is pushed higher, its upward elasticity diminishes. If the point of optimum productivity is reached, further upward elasticity disappears altogether. Elasticity may also be lost

¹ See p 512 of this volume.

where outside restrictions, established by constitutional or higher legislative authority, limit the rate which the taxing authority may impose. At present, the property tax levies of most local governments have reached the maxima allowed by constitutional or statutory limitations and are completely inelastic.²

Taxes whose rates are determined by regulatory rather than fiscal considerations are likely to be inelastic. This inelasticity is of little importance if the revenue yield is small. But when a regulatory tax is also a major revenue producer, such inelasticity may have unfortunate consequences. A classic example is provided by the federal customs duty. Protective tariff schedules produced more revenue during the 1880's than the federal government could use for any legitimate purposes, but customs rates could not be lowered without sacrificing protection. Federal financing "suffered" from a succession of annual surpluses which could not be expediently utilized.

Tax systems, as distinguished from individual taxes, are usually broadly elastic. When additional revenue is desirable, new taxes can be enacted. Some existing taxes can be dropped when an emergency is over. During World War I the federal government imposed scores of special levies and dropped them during the postwar years. During the 1930's, a number of states imposed "emergency" sales taxes for specific short periods.³ All too frequently, be it noted, "emergency" taxes develop into permanent elements of the tax system and the "elasticity" they represent operates in only one direction—upward.

Diversity of revenue sources

Upon occasion, theorists have proposed some single tax—a single land increment tax, or a single income tax, or a single sales tax—to produce all the revenue needed by a government. A single tax, they argue, would simplify considerations of individual or social distribution, would make the economic effects of taxation easy to calculate and control.

But no one tax, within the margins of its productivity, could cover

² See p. 397 ff of this volume.

³ See p. 562 of this volume.

all the current revenue requirements of American governments. And no one tax could encompass the elements of stability and elasticity essential to a revenue system. A set of taxes upon various aspects of personal capacity and economic behavior, rather than one single tax, is both necessary and desirable.

THE ADMINISTRATIVE PROBLEM

Legal validity, economic and social purpose, distributive justification, and revenue yield may all be defeated if a tax is not levied and collected according to legislative intent. No matter what the justifications advanced, a tax fails to the extent that it is avoided or evaded.⁴

Tax avoidance

False concepts of tax legislation or improper drafting of tax laws, rather than administrative laxity, make tax avoidance possible. The simplest and most obvious form of avoidance occurs when legislators in drafting a tax statute list a series of taxable subjects intended to be all-inclusive, but by oversight omit some particular classification. Any taxpayer may, thereupon, so organize his properties, activities, or business, as to come within the omitted classification. Even though the legislators never intended such exemption, the courts will hold the taxpayer beyond the reach of the taxing power, by the express provision of the statute. The intent of the taxpayer is immaterial—transactions authorized within the provisions of a tax law do not lose their immunity because the taxpayer is actuated by a desire to avoid the tax payment.

But blame for tax avoidance must not be directed exclusively against the legislatures. Our federal and state courts must take a

⁴ "Evasion" and "avoidance" are frequently used as synonyms in connection with tax matters. A useful distinction may, however, be drawn between them. "Evasion" should be applied to the escape from taxation accomplished by breaking the letter of the tax law—deliberate omission to report a taxable item, for example. The term "avoidance" is then available to cover escape accomplished by legal procedures which are contrary to the intent of the tax law's sponsors, but nevertheless do not violate the letter of the law. A federal income taxpayer who deliberately omits an item of taxable income from his return *evades* the law. One who devises a trust arrangement overlooked by the framers of the tax law, and thereby legally reduces his tax liability, *avoids* the tax. Whereas the tax evader breaks the law, the tax avoider sidesteps it.

large share of the responsibility. It has been a long-established precept of judicial construction that "In the interpretation of statutes levying taxes it is the established rule not to extend their provisions, by implication, beyond the clear import of the language used, or to enlarge their operations so as to embrace matters not specifically pointed out. In case of doubt they are to be construed most strongly against the Government, and in favor of the citizen."⁵ At times, in applying this sound principle, however, the courts have apparently taken the attitude that the taxpayer is always right, the taxing agency always wrong. They have construed tax statutes with ferocious strictness, and have applied the broadest of interpretations to constitutional limitations upon tax powers. In their anxiety to protect the individual's "liberty" from the "tyranny" of the taxing power, they have frequently ignored clearly expressed legislative intent. Fortunately for the development of sound taxation in this country, the federal courts and a number of the state courts have in recent years experienced a change of heart. To all appearances, current judicial construction is along the lines of sustaining legislative intent and administrative practice wherever a sound common-sense case can be made out in its favor.⁶ Federal tax legislation in particular has benefited considerably from this new judicial trend.

In the last analysis, allowing for favorable court construction, the only preventative for tax avoidance is simplicity and uniformity in tax statutes, eliminating exceptions and exemptions as much as possible.

Tax evasion

Tax evasion, breaking tax statute provisions outright, may result from legislative shortcoming. No tax law which outrages the sense of fiscal propriety can be well enforced. Twists of taxpayers' psychology assure the easy administration of some taxes and create difficulties in others. Most frequently, however, taxes are evaded because the law has not provided proper administrative machinery, or be-

⁵ *Gould v. Gould*, 245 U. S. (1917) 151. The above portion of this opinion has been cited in federal court decisions some 150 times.

⁶ For example, *Gregory v. Helvering*, 293 U. S. (1935) 465.

cause the organization and technique of the administrative machine are themselves at fault.

ADMINISTRATIVE PRINCIPLES

Over a hundred and sixty years ago, Adam Smith set forth four so-called "maxims" of sound taxation.⁷ The first, relating to the distribution of tax burdens, was quoted earlier in this volume.⁸ The remaining three read as follows:

II. The tax which each individual is bound to pay ought to be certain and not arbitrary. The time of payment, the manner of payment, the quantity to be paid, ought all to be clear and plain to the contributor and to every other person.

III. Every tax ought to be levied at the time, or in the manner, in which it is most likely to be convenient for the contributor to pay it.

IV. Every tax ought to be so contrived as both to take out and keep out of the pockets of the people as little as possible, over and above what it brings into the public treasury of the state

These three maxims—often referred to as the maxims of certainty, convenience, and economy—are as applicable to the American tax system today as to the English revenue system of 1776. Indeed, with some slight elaboration, they constitute the administrative theory of taxation.

No sane human being is ever expected to be enthusiastic about a tax he must pay. But passive acquiescence, and a certain grudging cooperation, on the part of most taxpayers is necessary to the effective administration of any tax. No small corps of officials, however well-intentioned and well-trained, could successfully levy and collect a tax from a population stubbornly resisting them at every phase of their task. Having relieved their feelings by grumblings and complaints, the main body of taxpayers must be willing to list land, buildings, and cattle, to subtract "the total of items P, D, and Q" from "the difference between items X and Y" in calculating net in-

⁷ Smith, *The Wealth of Nations*, Book V, Ch. II.

⁸ See p. 287 of this volume.

come, to report salaries and wages paid employees. The legislator and administrator cannot ignore public sentiment toward different taxes and different ways of collecting taxes. And to a great extent, public sentiment is determined by the certainty, convenience, and economy with which a tax is levied and collected, and by the derivative factors of familiarity and tax consciousness.

Certainty

Confused tax law provisions or regulations inspire resentment on the part of taxpayers, and contribute to tax avoidance. If there are two alternative interpretations of some detail of tax liability, the taxpayer will naturally choose the one involving the lower tax payment. Should the administration overlook the point, a possible avoidance is perpetrated. Or, if the administration spots the irregularity, the outcome is an embroglio which leaves the taxpayer aggrieved if not embittered.

Simplicity in tax legislation is the first step toward tax certainty. Of course, a tax applying to a complex subject, such as net income or "corporate capital stock employed within the taxing state," cannot be covered by the phraseology of a children's primer. Nevertheless, the substance and language of most tax statutes could be simplified considerably without impairing the situation of those whose complex personal and business interests cannot be taxed justly under an elementary law. Typographical tricks—the use of varied types in printing the law, catchwords, head-notes, indentations, and the like—can, without sacrificing legalistic exactitude, be used to guide the taxpayer. And no principle of lawmaking requires sections and clauses of a tax law to be jumbled in haphazard confusion, regardless of logic or common sense—a type of statutory organization that for some obscure reason holds peculiar fascination for state legislators.

Legislators are not the sole contributors to the taxpayers' bewilderment. After Congress enacts a tax statute, the Treasury supplements the law with regulations, and amends the regulations with frequent "decisions." The Bureau of Internal Revenue and the General Counsel make both published and unpublished rulings and interpretations, and mimeographs attempt to convey to officials the policy

and attitude of the administration. Judicial interpretation then enters. Every federal district court, the Board of Tax Appeals, and the Court of Claims, establish the law in those cases over which they have original jurisdiction. Circuit Courts of Appeals hand down binding interpretations. The Attorney-General's opinions on tax matters are controlling on the administrative authorities, and the Solicitor-General governs the Bureau by determining the cases in which to apply for or consent to review, and the cases in which to acquiesce in lower court decisions. And the Supreme Court has final word in the limited class of cases which reach hearing there. No less than thirteen sources, with diverse aims, backgrounds, and equipment, contribute to the stream of tax law vexing and confusing federal taxpayers. Similar complication of interpretative agencies confuses the meaning of state tax laws.

Upon administrative agencies rests the responsibility to prepare simple tax forms and regulations. In recent years the federal Bureau of Internal Revenue has taken this responsibility seriously, and the forms and regulations for various of its taxes have been markedly improved. Some state tax administrations have also sought to reduce taxpayers' uncertainty by issuing clear, concise instructions. In too many cases, however, state tax forms and regulations are still carelessly and vaguely drawn.

Confusion resulting from arbitrary and hairsplitting judicial interpretations cannot be cured while tax issues remain subject to court review. And under a system of constitutional government, this means forever. Uncertainty is part of the price paid to protect individual liberties and rights from arbitrary encroachment by governmental action.

Familiarity

In fiscal matters, familiarity breeds not contempt but resignation and understanding. Heated though the opposition to a tax may be upon the occasion of its first levy, opposition wanes if the tax can survive popular distrust for a few years. As taxpayers become familiar with the routine of filling in the tax forms, calculations which once seemed hopelessly intricate become simplified through

repetition. A National Tax Association committee on simplification of the federal income tax reported in 1927:

Once a clear statement of general principles is enacted, it should remain unchanged in verbiage. Five or even ten years may be necessary for a clear comprehension of a statute to sink into the intelligence of a great mass of the taxpayers.⁹

Administrative procedure crystallizes into efficient routine, and disputes between taxpayers and the administration decrease in number as regulations, rulings, and decisions clarify the tax law. During the 1920's it looked as though Internal Revenue officials might be swamped under the income tax disputes and back tax cases piling up on them. But as precedents were established for the points in dispute, they were able to clear away this backlog, and approach a current basis of operations. Furthermore, long continuance of a tax permits the courts to pass upon the disputed points in its construction, and as these clear up, the task of administration is eased.

Administrators give much weight to acquiescence as a factor in tax laws of long standing. Once a tax is established, they are loath to change its base substantially or to substitute another, even though the original tax be proved unjust in its distributive application and susceptible of some degree of escape and avoidance. Unsatisfactory as the first tax may be in many respects, its general acceptance makes it a certain source of revenue. Popular prejudice may ruin the second tax, for all that it is superior by every theoretical standard. Similarly, administrators faced by the need for additional tax revenue always prefer an increase in the rates of existing taxes rather than the levy of a new tax. And taxpayers are irked less by a heavier tax levied under a familiar system than by a lower, but new, tax requiring new calculations and new procedure.

Special effort on the part of the tax administration can, however, avert much of this popular prejudice. The alert administrator must turn missionary when existing taxes prove insufficient, and some new tax is levied. He becomes a sales executive with a new com-

⁹ National Tax Association, *Proceedings of the Twentieth National Conference*, 1927, p. 114.

modity to sell and he must advertise its virtues. The new tax can be publicized through press releases, through special articles and question-and-answer columns in trade newspapers, magazines and the general press, and through speeches before civic organizations and taxpayers' associations. To gain taxpayers' goodwill, committees should be consulted upon practical details of accounting procedure when reporting forms are being prepared. Taxpaying groups may also be consulted in the formulation of the interpretative regulations for the tax. And no wise administrator is arbitrary or bureaucratic in the actual administration of a new tax. Where conciliation and compromise are warranted, he conciliates and compromises. Obstinate insistence on his personal interpretation of a detail of the tax law would arouse taxpayer resentment and induce avoidance or evasion or even resort to litigation costly to both parties. One of the leading tax administrators in this country comments that a tax administrator supervising the imposition of a new tax must be a "referee, standing between the state on the one hand and the taxpayer on the other, with the sole idea and desire of seeing that both get a square deal."¹⁰

Convenience

Taxpayer convenience and administrative convenience or efficiency are not mutually contradictory. Rather, the two are in close harmony. To the extent that the details of a tax law and its regulations conform with taxpayer convenience, they contribute to popular acquiescence in the tax, and ease the problems of its administration. An excellent example of the mutuality of taxpayer and administrative convenience is the arrangement for "tax anticipation notes" made by the federal Treasury in 1941. Taxpayers were enabled to spread the burden of their heavy 1942 income tax liability by monthly purchase of these notes bearing 2 per cent interest. The Treasury, on its part, received some of its 1942 income tax revenue in advance through sale of the notes.

While most tax statutes are drafted with the convenience of the taxpayer in mind, this factor is occasionally overlooked. The 1936

¹⁰ Letter from the Honorable Mark Graves, of the New York State Tax Commission.

undistributed profits tax, for example, was deservedly criticized because corporations were given no time margin for determining dividend policy after the close of their accounting year.¹¹ Usually, subsequent amendments of new tax laws correct these oversights. Sometimes, however, legislative indifference results in the persistence of a stupid provision. Instalment payment of property taxes would be a boon to most urban property owners, and would probably eliminate some property tax delinquency. None the less, until very recently, statutory provision for semiannual or quarterly payment was exceptional. Annual payment had harmonized well enough with the rural economy which existed when the original property tax statutes were drawn, and it was continued long after the justification for it had disappeared.

But bureaucratic indifference of the tax administration is the most common cause of taxpayers' inconvenience. Scores of thousands of rural property tax collectors throughout the country still refuse to send out tax bills, and taxpayers must discover the amount of their obligation from lists posted at the collectors' offices. In the past, overcentralization of review procedure, compelling taxpayers to journey to state capitals or to Washington to settle minor disputed points, was a vicious source of irritation. In 1938, the federal Bureau of Internal Revenue decentralized and distributed its review procedure among ten regional divisions, each of which operates through local offices. The district officials' responsibility in settling disputed issues was increased.¹² Some improvement along these lines has also been made in the field of state tax administration.

Economy

Assessment and collection of any tax involves costs. Office space must be provided, equipment and materials must be purchased, officials' and employees' salaries must be paid. No one can cavil at the admonition that, in fairness to the taxpaying public, these adminis-

¹¹ See pp. 501-502 of this volume.

¹² The improvement in tax administration resulting from this action is described in Arthur A. Armstrong, "Decentralization of the Bureau of Internal Revenue," *Taxes*, February 1941, pp. 90-102.

trative costs should be held to a practicable minimum. But a low administrative cost is not per se an indication of a good tax or a good administrative agency. The problem of administrative economy is not that simple. What ratio primary administrative costs bear to tax collections depends upon a number of factors—the taxes imposed, the efficiency of the administration, and the intensity of administrative effort. And not to be overlooked are the secondary administrative costs—the “compliance costs” imposed upon taxpayers.

The costs of administering the various taxes differ widely. A specific tax on commodities or legal documents involves a minute administration cost if it can be collected by the sale of stamps which must be affixed to the articles or documents. Administrative costs of retail sales taxes, including compliance costs, amount to five to ten per cent of collections, about the same ratio as for personal income taxes.¹³ A personal income tax, requiring detailed auditing and review of complicated returns, is expensive to administer. As a general rule, it will cost less to administer a commodity tax whose collection can be centered on a few large-scale producers or wholesalers, than one collected from a multitude of small dealers or consumers. For this reason, the states collect their gasoline taxes from the distributing companies rather than the service stations. Were the federal government ever to impose a general sales tax, it would be more economically levied as a manufacturers' excise than as a retail sales tax.

Another general rule is that, within limits, the ratio of administrative cost of any tax varies inversely with its rate. A one per cent retail sales tax and a two per cent retail sales tax involve exactly the same number of returns, but the revenue of the latter, while not necessarily double, will be much larger. Administrative effort and costs will advance somewhat, since the higher rate will hold out more inducements for evasion, but—unless the rate of the tax is pushed beyond the optimum point—not *pro rata* to the increase in

¹³ Neil H. Jacoby, *Retail Sales Taxation* (Commerce Clearing House, Chicago, 1938), p. 352.

revenue. And finally, high minimum exemptions in personal and business taxes reduce the relative costs of administration. A personal income tax return submitted for a one or two dollar payment costs that much or more to audit, file, and possibly check. And this tremendous administrative cost produces no net revenue. If small returns are eliminated by an exemption, administrative costs are reduced with little or no loss of net revenue, and the ratio of administrative costs to the total revenue is lowered.

The inverse relationship between relative administrative costs and administrative efficiency is an obvious one. Irrespective of other factors, an efficient tax administration costs the public less than an inefficient one. But a low ratio of costs does not necessarily indicate an efficient tax administration. A tax office that makes no attempt to discover avoidance or check evasion, that contents itself with accepting such revenue as is voluntarily paid in, will of course show a very low ratio of costs to revenue. Another office that genuinely seeks to collect the full amount of taxes payable under the law, that seriously audits returns and makes sample checks, that provides the review machinery necessitated by its more intensive enforcement of the law, will collect much more revenue, but it will have a higher ratio of administrative costs. Low tax costs resulting from administrative indifference are as much an indication of injury to the tax-paying public as high costs resulting from inefficiency.

And finally, most taxes impose "compliance" costs on the taxpayer. An individual who in the course of the year devotes hours to keeping tax records and calculating income tax liability is spending valuable time without compensation. Large business concerns must employ a special clerical staff to handle tax matters, must pay lawyers and accountants for tax services, must occasionally engage in expensive tax litigation. A 1934 survey of 163 business corporations reported an average "compliance" cost of 2.3 per cent of taxes paid. On the average, each corporation filed 39 federal and 152 state and local primary tax returns, and approximately 1000 information reports.¹⁴

¹⁴ Robert M. Haig, *The Cost to Business Concerns of Compliance with Tax Laws* (American Management Association, New York, 1935).

Tax consciousness

When an individual is taxed in his private capacity, on the income he earns, or on the property he owns, he pays out funds which he would otherwise have used for a new suit of clothes, for an extension to his house, for a vacation trip, or for some other personal gratification. To taxpayers, a personal tax always seems a direct deprivation, and it is resented accordingly. Nor can a taxpayer help being hyperconscious of the check he writes and mails to the tax collector.

A business man, on the contrary, regards his taxes as one of the many costs entering into his business operations. He does not feel it as a special deprivation, any more than he considers his rent, the prices he pays for raw materials, and his wage and salary list special deprivations. Furthermore, a majority of business men have a vague notion that any business taxes, even net income taxes, are shifted eventually to the consuming public. If the government wishes, let it lay taxes on them, somehow, they will increase their prices, and so pass on the tax. So business taxes appear much less obnoxious to the concerns that pay them than personal taxes do to individual taxpayers.

Through the mechanism of price increases, as we have already seen, commodity taxes generally and many business taxes are shifted to consumers. Moreover, this shifting of commodity and business taxes produces a markedly regressive burden. Economists, editors, and occasional politicians have repeatedly informed the masses of their exploitation by such indirect taxes. But because consumers do not directly hand dollars and cents to a tax collector, they fail to recognize the tax burden imposed upon them. They are not *conscious* of any tax payment. And so commodity and business taxes, though generally shifted, invoke little popular opposition.

From the administrative viewpoint, a levy which arouses no "tax consciousness" is preferable to one which does. The problem of combating evasion is milder for the former than for the latter. Nevertheless, administrative considerations are not the only ones which enter this issue. As we noted in previous chapters, the per-

the Civil War. One year later the office was renamed "Commissioner of Internal Revenue," and was charged with the collection of all federal taxes other than the customs duties. The country was districted, and a field force of several thousand assessors, collectors, and inspectors was built up. As the federal internal revenue system was reduced to a few excises following 1870, the importance of the Internal Revenue office tended to decline.

In 1909, with the enactment of the federal corporation excise, the federal Bureau of Internal Revenue entered a new phase of development. A special Corporation Tax Division to handle the new tax was organized within the Bureau. In 1913 a Personal Income Tax Division was similarly organized to administer the newly enacted federal personal income tax. With the passage of the war revenue acts, new units and divisions were organized, and administrative and field personnel increased; by June 1920 the latter numbered 20,159. Again the functions and personnel of the federal Bureau of Internal Revenue shrank as the war taxes were abolished and departmental economy was introduced only to expand again after 1933.

In 1919 an Advisory Tax Board, to be composed of six members appointed by the Commissioner of Internal Revenue, was provided; to it the Commissioner might submit problems on the interpretation of the federal tax laws as they applied to individual taxpayers. Within a few months, this Board was reorganized as a Committee on Appeals and Review, and given the status of an independent Bureau unit. This Committee proved to be an unsatisfactory hybrid which exercised quasi-judicial functions, but whose findings lacked judicial finality. In 1924 its functions were transferred to the newly created Board of Tax Appeals, which, completely independent of the Federal Treasury, was given somewhat the character of an inferior federal court. This Board has become a valuable link in the chain of federal tax procedure, and there is reason to believe that it will long continue a feature of the federal system of tax administration. Not all controversies between taxpayers and federal tax assessors go directly before the Board of Tax Appeals. Many issues are settled by a Special Advisory Committee or by the Review Division of the Bureau of Internal Revenue itself.

State tax organization

The characteristic organ of state administration is the state tax commission. More rudimentary bodies—state boards of review and equalization—are found in some states. A few states have achieved a further stage of development, and tax administration has been made a function of the state department of finance. But in two-thirds of the states, tax administration is at present in the hands of state tax commissions.

Prior to the Civil War the general property tax, administered by local assessors and collectors, was the sole source of revenue in many states. Administration of the occasionally levied death taxes or other special state taxes was entrusted either to the local property tax officials or incidentally to some state department. State tax administration machinery first appeared in the 1850's when Indiana, Iowa, Michigan, New York, and Wisconsin created state boards of equalization.¹⁷ Within three decades most states had established similar boards. Assessment of the operating property of railroads and other public service corporations was taken from the local assessors in many states and entrusted to the state boards of equalization. So, too, administration of special state taxes was increasingly delegated to these bodies.

State boards of equalization with their characteristically large ex officio or elected membership, were too cumbersome for the procedure of administration; they were not fitted actually to administer important state taxes. Indiana in 1891, and many states thereafter, provided a state tax commission to replace the state board of equalization. A distinctive feature of these new bodies was their small, and usually appointed, membership. To them were entrusted, as a rule, administration of special state taxes, and more or less supervisory authority over local tax officials and property tax assessments.

Except for Delaware all the states now have some state official or body charged with tax administration.¹⁸ In two-thirds of the states,

¹⁷ For consideration of the function of state equalization, see p. 392 of this volume.

¹⁸ Administration of several important Delaware taxes whose proceeds are earmarked to the state school fund is centralized in a State School Tax Commissioner.

tax administrative powers are entirely in the hands of a tax commission, a tax commissioner, or some board of finance or revenue. Other states have two tax bodies—a board of equalization for property tax matters and a tax commission or equivalent body administering other state taxes. Although five still limit themselves to state boards of equalization, in several cases the powers of the boards have been so broadened as to make them practically tax commissions.

The old boards of equalization usually had a large and *ex officio* membership. Sometimes they were composed exclusively of state officials, sometimes county assessment officials were given places. Tax commissions, in contrast, commonly have three members, though that of Nevada has seven. And a good many states concentrate all tax administrative functions under a single commissioner, who is more likely to be an appointee of the governor than an elected official. Some tax commissioners hold office at the pleasure of the governor, but a specific term of office—generally four or six years—is customary. Arkansas and Wisconsin provide the longest term—eight years.

Both tax commissions and boards of equalization are required to assess the property of public service corporations. In a few states they also assess mining property. Not infrequently, the commission or board reviews assessments on appeal from local or county assessment officials. In nearly all of the states it is provided that the state board of equalization or, where the board has been supplanted, the state tax commission or commissioner shall equalize property tax assessments between counties. Less frequently the state tax bodies have power to equalize between local districts, between classes of property, and between individual properties. In almost all states, the state tax commission or the state board of equalization has general supervisory power over the procedure of property assessment. In a majority of the states, these bodies are specifically authorized to order or make reassessments when circumstances warrant. Sometimes they are also empowered to prescribe property tax forms, to prescribe maps, and to remove or cause the removal of local tax officials.

Besides their property tax functions, state tax commissions and

commissioners are generally charged with administering other state taxes—corporation franchise and privilege taxes, personal income taxes, inheritance taxes, chain store taxes, and sales taxes. Occasionally they also administer motor vehicle license taxes, motor fuel taxes, bank taxes, insurance company taxes, and other revenue laws.

Machinery for the administrative review of state tax assessments and levies is still unsatisfactory in many states. The demarcation between the scope of administrative review and that of judicial review is not always clearly drawn, and frequently issues which should be settled across an administrative official's desk are litigated. Rarely, too, is the reviewing authority of each grade of administrative official clearly defined, and subordinates, fearful of exceeding their hazy responsibility, prefer to "pass the buck" to their superiors. When, as often happens, a tax commission itself assesses some item for taxation, review is possible only if the commission subsequently sits as a board of review and passes on its own acts as an assessing agency. Some tax commissions seem capable of listening with open mind to appeals from their own assessments, and doing duty in the dual capacity of assessor and board of review in a manner to retain the respect and support of the taxpayers concerned,¹⁹ but the arrangement is far from satisfactory. Independent state boards of tax appeals, with quasi-judicial status, similar to the federal Board of Tax Appeals, would appear to be a necessary agency of state tax administration.

Local tax organization

In rural districts, the local assessor and the district or county tax collector comprise all the necessary tax machinery. Property assessment in cities is a more technical matter, and extensive systems of urban license taxation often involve additional administrative problems of no mean order. Despite its importance, however, attention is rarely given to the development of city tax administration.

Tax administration in most cities was entrusted initially to an elected board of tax assessors, and many such boards are still to be

¹⁹ See Harley L. Lutz, "Some Essentials of Good Tax Administration," *Proceedings of the Twenty-Ninth National Tax Association Conference*, 1936, p. 324.

found. While the law assumes that property is valued by the joint action of such a board, in practice each member is frequently responsible for the assessment of a particular portion of the city. But sufficient clerical assistance is rare, and the assessors spend so much of their time on routine clerical work that performance of their administrative duties is perfunctory. Moreover, elected boards of assessors all too often fall under the influence of dominant political machines and become focal centers of graft and corruption.²⁰

In recent years large cities and the more progressive smaller ones have departmentalized the procedure of tax assessment. A clerical force collects the information on property values, records that information, and performs the mechanical calculation of applying unit values to taxable sites.²¹ To more responsible individuals is reserved the discretionary function of determining unit values. Cities with established property tax departments frequently transfer to them the function of collecting special revenue charges and license taxes.

Centralization of tax administration

Of necessity, federal tax administration has always been strongly centralized, all authority radiating from Washington. At the time of the Civil War, almost every step in state tax administration was in the hands of local officials. Since then a trend in the direction of centralized state tax administration has been steady, but the tendency has not been so far fulfilled that the question may be considered closed. In fact, centralization of property tax assessment and collection remains a subject of sharp controversy in many states.

The movement for centralization of tax administration has a double objective—to unify the tax administration of a particular governmental unit, and to transfer tax functions from local officials to state or even federal officials. Federal tax administration has always been highly unified. Customs duties are assessed and collected by the Customs Service, and all other federal taxes are collected by

²⁰ On this point read the fascinating account of tax corruption in Chicago during the 1920's in Herbert Simpson, *Tax Racket and Tax Reform in Chicago* (Institute for Economic Research, Chicago, 1930).

²¹ See p 376 of this volume.

the Bureau of Internal Revenue. In view of the dissimilarity between taxes administered by the two departments, and the different problems involved, a strong case can be made out for the continued separation of the two units.

An astounding lack of administrative unity in tax assessment and collection is displayed in a number of states. We may take, as an outstanding example, the Illinois system of tax administration, summarized in Table 15. The motivating cause of such heterogeneity of administration is to be sought in the development of the tax system. Many of these taxes were originally fees attached to particular state offices, and, although they evolved into taxes, no step has been taken to unite their administration with that of other taxes. When tax administration thus remains an incidental function of a series of state departments whose main interests and duties lie in other directions, the development of a consistent effective technique of tax administration is an impossibility.

Administration of all state taxes, except possibly those of a purely regulatory character, should be unified under a tax commission or department of finance. Such unification, as has been pointed out by a noted administrator,²² has among its advantages, the following:

- (1) Intensive and intelligent application to the work by executives
- (2) Wider experience and more practical knowledge of tax matters by administrators
- (3) Ability to assign adequate clerical forces for peak-load periods
- (4) Increasing elevation of standards of administration for each new tax
- (5) The development of specialists
- (6) Economy in administration by doing a wholesale rather than a retail business—in other words, quantity production
- (7) The convenience of the taxpayers
- (8) The adoption of a functional distribution of administrative powers

City governments which, in addition to their property taxes, levy

²² Mark Graves, "Administration of State Taxes as Viewed by an Administrator," in *Annals of the American Academy*, Vol. 183, January 1936, p. 190.

TABLE 15
STATE TAX ADMINISTRATIVE AGENCIES IN ILLINOIS

| Agency | Assesses | Collects |
|---|---|-----------------------------------|
| Tax Commission | Railroad properties Corporation capital stock Supervises local assessment | |
| Department of Finance | Sales tax Gasoline tax Liquor tax | same same same |
| Secretary of State | Automobile registration charge Corporation organization and franchise taxes Securities registration tax Miscellaneous license taxes | same same same same |
| State Treasurer . . | Athletic exhibitions tax | same Charter rail- road tax |
| Department of Agriculture | Horse race tax | same |
| Insurance Department . | Domestic insurance company tax | same |
| Department of Trade and Commerce | Foreign insurance company tax | same |
| Department of Registration and Education | Various trade and profession license taxes | same |
| Commerce Commission. . | Public utility securities tax | same |
| Auditor of Public Accounts | Charter railroad tax Building and loan associations tax Trust companies tax Foreign exchange dealers tax | same same same |
| Department of Conservation | Game and fish license taxes | same |
| Department of Labor | Employment agencies license tax | same |
| Aeronautics Commission . . | Taxes on airports, air schools, landing fields | same |

special license taxes should entrust their administration to the department charged with administering the property tax. Scattering the administration of these charges among departments mainly interested in other functions results in indifferent assessment and collection.

Nowhere has the morbid distrust of governmental bureaucracy engendered by America's colonial experience expressed itself with more obstinacy than in the field of tax administration. Since the tax power was considered a possible weapon of tyranny, it was felt that those who wielded the power should never be trusted far from the people's reach. But some taxes simply could not be administered locally. Assessment of public service corporations with their complex integrations of property was obviously beyond the power and capacity of local tax officials. Similarly, the administration of an income or a death tax required a technique too intricate to be entrusted to a three-dollar-a-day assessor. As special taxes on public service and other corporations were enacted, their administration was given to various state departments. Income and death tax administration was made a state function. Local governments might be permitted to share in the revenue from these taxes, but they were allowed no share in their administration. Some elements of state centralization were introduced even in the case of the property tax. In states where the property of public service corporations remained subject to taxation, the state tax commission or some corresponding body was empowered to assess, if not to collect, the tax. In a few states, the function of assessing the corporate excess of mercantile and manufacturing corporations was taken from the local assessors.

The general property tax remains the last stronghold of local tax administration. Local assessors, it is argued, know and understand their communities better than state officials, and they have the goodwill of the people whose property they assess to a greater degree than outsiders could ever gain. On the other side it is argued that all these advantages of local assessment could be retained by requiring centrally appointed assessors to be residents of their districts. Such assessors would be amenable to the discipline of the central administrative body and could be required to measure up to its technical

standards. Sentiment for fiscal localism dies hard, and complete state centralization of property tax assessment has not yet been achieved in any state, although there has been some headway in making tax assessment a county rather than a district function.

Administrative personnel

Another unfortunate example of the American mistrust of bureaucratic government is this country's penchant for elected tax officials. The office of assessor is generally an elective office. Some of the higher tax administrative officials—members of the county boards of review, members of the state boards of equalization, even a few tax commissioners—are also elected.

Tax administrative functions are ministerial, not executive or legislative, and there is, consequently, no reason why tax officials should be elected. There are many reasons why they should *not* be elected. Election of tax officials generally results in periodic changes of personnel, and the officeholder does not have the opportunity to familiarize himself thoroughly with the complicated technique essential to administrative efficiency. Furthermore, elected officials, particularly assessors, are always tempted to subordinate their office to political considerations, to curry favor with their constituents by open or concealed underassessment.

All students of the problem agree that the appointed tax official is the most effective administrator. It is also generally agreed that such officials should be appointed for a term long enough to ensure thorough mastery by the incumbent of the details of administrative technique. Dangers inherent in long tenure of bureaucratic offices can be guarded against by vesting power of removal in some higher official or body. The possibility of transforming elected tax officials into appointed officials is closely associated with the movement for centralized tax administration.

Membership on local and county boards of review is usually an *ex officio* function of such other local offices as mayor, town clerk, county clerk, county supervisor, and so forth. As a general rule, *ex officio* functions are not performed with a high degree of efficiency, since the individuals charged with their performance are likely to

view them as incidental to the major functions of their proper offices. In the case of local and county review and equalization, however, except for the largest cities, the function is exercised for too short a period in each year to be attached to an independent office. Ex officio county and local boards of review and equalization are probably the most practicable agencies.

Subordinate tax administrative personnel should be, and now generally is, under the merit system. Unfortunately, there persists a tendency to consider tax work a relatively low grade of civil service, and salaries for the most part are low. But even in the subordinate grades, tax administration requires individuals of high caliber. Federal and state tax offices succeed in obtaining a supply of able young men fresh from law and accounting schools but, in the absence of salary inducements and opportunities for advancement, they have not been able to hold them. After a few years of service, during which these young men obtain valuable experience and establish useful contacts, they desert the tax offices for private practice. Turnover among the federal and state tax personnel has in the past been unhealthily high, with consequent damage to the services in question. The federal Bureau of Internal Revenue has taken steps to make its employment a career service. State tax bureaus, apparently, are still relying on pious hopes rather than tangible rewards to hold their personnel.

ADMINISTRATIVE TECHNIQUE

Through long experience, certain details of the administrative procedure of taxation have been marked as faulty, and others as advantageous. An adequate social science, with tested first premises, might have arrived a priori at the conclusions which tax administrators have slowly evolved from their day-by-day experiences. Since there exists no adequate social science, however, the art of tax administration must look to the empirical discoveries of active tax administrators for guidance.

Assessment technique

A business enterprise numbering its clients or customers by the thousands must devote keenest thought and care to the development

of filing and cataloguing systems through which it can reduce most of its relations with clients or customers to an orderly routine. A haphazardly run tax office can no more be successful in its operations than a carelessly conducted business enterprise. If evasion is not to be widespread and if the taxpayers' money is not to be wasted in inefficient tax assessment and collection, a technique of tax administration must be developed.

The first requisite is a complete and constantly up-to-date record of persons and business concerns liable for each tax. In the case of property taxes, the tax assessor must keep files of all land transfers recorded in the county clerk's office. For income taxes, information on salaries paid and on other sources of income must be obtained from the individuals and business concerns making disbursements. Corporation taxes require the administrator to obtain from the secretary of state or other official charged with recording the organization and entrance of corporations information about corporations active in the state. Obvious though this procedure may appear, it is neglected in a surprising number of cases. Every investigation into general property tax assessments uncovers instances of parcels of land carried in the names of former owners for years after they have disposed of all interest in the properties. Until recent years, public opinion has been hypersensitive about the use of private and even public records in determining tax liability. And government departments are markedly adverse to exchanging information necessary to the efficient performance of each other's duties. Many state and local tax departments today depend upon chance to uncover those individuals or business concerns liable for some tax who do not appear on the lists.

Assessment technique differs according to whether the tax officials or the taxpayer makes the assessment. The one important tax assessed by tax officials is the general property tax. For a century, the methods of assessing personal property have remained largely unchanged, and the assessor still has no assurance that all taxable personal property is included in his lists or that his valuations are adequate. The technique of assessing real property, however, has made notable progress in recent years. Efficient assessment offices, both

urban and rural, utilize tax maps on which each parcel of taxable property is indicated and key-numbered. Some states are using air-plane surveys to make photographic tax maps of broad sections of their territory. In some regions, determination of land values must depend to a large extent on the judgment of the individual assessor, checked occasionally by prices obtained on land sales. But cities can develop more systematic methods of valuation. Unit values for land in various sections of the city and even in particular blocks can be determined by a study of sales prices, and the information embodied in land value maps. These block or neighborhood unit values are then applied to the individual parcels of land, various formulae being employed to adjust the unit values to irregular-shaped lots.²³

No such systematization of assessment is possible where the taxpayer makes the assessment or valuation. Nevertheless, the tax administration is not completely at the taxpayer's mercy in the case of income taxes, death taxes, and business taxes based on gross receipts, turnover, and so forth. It has two weapons against evasion in self-assessed taxes—information from outside sources and the sample check. In some cases the obtaining of information from outside sources can be routinized. Newspaper clippings can supply an alert administrative staff with intimations of evasion by prominent individuals. Cross checks can be made between personal income, inheritance, and corporation tax returns. For the income tax, employers can be compelled to report salary and wage payments, corporations can be compelled to report dividend payments, publishers can be compelled to report authors' royalties, and so forth. When assessments are published for gross receipts and stock-in-trade taxes, business rivals often report cases of understatement to prevent their competitors from obtaining a business advantage through tax evasion. Written complaints, frequently anonymous, disclose many instances of evasion which might otherwise pass undiscovered. Some states have experimented with "tax ferrets"—informers paid a percentage of the evaded taxes recovered through their information. While it would seem that only tax evaders could object to

²³ The technique of property tax assessment is discussed more fully on pp. 376 ff. of this volume.

"tax ferrets," the system has provoked popular outcry wherever tried, and the only important example of its use at present is in the federal customs duties.

The best weapon against evasion of self-assessed taxes is the sample check. A tax administration cannot, of course, minutely investigate every one of the tens of thousands of tax returns. Only 7 per cent or so of the millions of personal income tax returns submitted are carefully examined by the federal Income Tax Unit. But fear of possible detection is almost as effective as the certainty of detection in preventing evasion. A small "flying squad" of accountants, settling for a few weeks in some small town, then in some section of a large city, then moving again to some unknown destination, can in the course of a year examine carefully into the reports of several thousand taxpayers. Evasions discovered in this check are punished by the maximum penalty, and full publicity is given to their discovery and punishment. Thus to be made an example before his neighbors may seem disproportionate punishment for the evader caught by this procedure, when others escape examination and detection. But the tax evader has only his own sharp practices to thank, and the publicity given to his case is salutary warning to prospective evaders. The federal government, New York State, and several other industrial states, employ the sample check in the administration of some taxes.

The tax oath

When a tax is based on a report prepared and submitted by the taxpayer, the law customarily requires him to affix an affidavit that the report is true in all its details, or at least true to his knowledge. In practice, tax officials frequently waive the signing of this affidavit and accept unsworn tax reports. Tests made in several states indicate, however, that waiver of the tax oath is a costly oversight, since it is surprisingly effective in reducing evasion.

Why should a mumbled sentence and the signing of a name on a dotted line convert a prospective tax evader into an honest taxpayer? Undoubtedly the sacredness of the oath is the determining factor in some cases. Many a man will lie freely and bare-

facedly so long as he is not compelled to make the Deity surety for his word. Fear of possible prosecution for perjury may also be influential. Cases where a tax evader has sworn falsely to his return and has been indicted, tried, and punished for perjury are rare. Nevertheless, many individuals who would chance the civil wrong of making a false return with its punishment of monetary penalties upon discovery, hesitate to involve themselves in the criminal wrong of taking false oath.

Tax penalties

Honest, consistent, and expeditious administration, it has been found, will secure voluntary observance of tax laws from most taxpayers. Among this tractable majority are many taxpayers who make mistakes through innocent ignorance or carelessness. They should be treated with lenience. Some occasionally succumb to venturesome impulses and seek "to put over" a little cheat on the tax bureau. And, finally, there are always some "tax outlaws" who will willfully evade any and every tax if there is a chance that their evasion will succeed. For these last two classes there must be tax penalties, mild for the venturesome, suitably severe for the "outlaws."

To make tax evasion a criminal act punishable by heavy fine or imprisonment is a punishment which generally fails through over-severity. On this ground juries persistently refuse to convict a person indicted for tax evasion, when such conviction would make him liable to a jail sentence. Punishment for evasion should take the form of a monetary penalty specifically provided by the tax statute. In the case of license taxes of fixed amount, it is possible to provide for a fixed penalty, say of \$100, \$500, or \$1000. For taxes levied on bases such as property, income, or the size of an estate, the penalty should be proportioned to the amount of evasion.

PART III

AMERICAN TAXES
AND OTHER CURRENT REVENUES

CHAPTER XIV

American Taxes

Tax revenue is the main support of American governmental activity. At times the federal government or particular state or local governments may raise more by borrowing than by taxation, but most governmental loans must eventually be repaid from funds raised principally by taxation. Rather than an independent, competing source of governmental revenue, borrowing is, in effect, a method of equalizing tax burdens over periods of time or of postponing resort to taxation. In some instances, commercial and sovereign revenues, and charges for special governmental services, discussed in a later chapter,¹ take the place of taxes. Many of them, however, are indissolubly attached to particular governmental activities, and funds so derived are not available to finance the major group of governmental functions. And compared with tax revenues, they constitute a very minor item of governmental revenue.

GENERAL STATISTICAL ANALYSIS

Governmental expenditures in the United States, as was shown in Chapter III, have long been on the increase. Perforce, tax revenues have had to increase. But the growth of expenditures and tax revenues has not been strictly parallel—heavy federal borrowing during World War I, partial repayment of this debt during the 1920's, renewed federal borrowing in the 1930's, and the variations of state and local borrowing and debt retirement, introduce a variant of considerable magnitude between the trends of expenditures and of revenues. A long-term interrelationship, however, exists between the two.

¹ See Chapter XXIV

Growth of American tax revenues

From 1890 to 1913, American tax collections rose from \$875,000,000 to \$2,193,000,000, a 150 per cent increase. Federal war tax collections and some expansion of state and local tax systems lifted total tax receipts to a peak of approximately \$9,200,000,000 in 1920. Three years later federal taxes had been reduced by \$2,700,000,000, state and local taxes had increased \$700,000,000, and the total figure

TABLE 16
AMERICAN TAX REVENUES, SELECTED YEARS 1890-1940

| Year | Amount (in millions) | | | | | Per Capita "1926" Dollars ¹ | Ratio to Na- tional Income |
|------|----------------------|-------|--------|--------|--------------------------------------|---|-------------------------------------|
| | Fed- eral | State | Local | Total | In "1926" Dollars ¹ | | |
| 1890 | \$ 374 | \$ 96 | \$ 405 | \$ 875 | \$ 1,557 | \$ 24 70 | 7 2 |
| 1903 | 517 | 159 | 705 | 1,381 | 2,317 | 28 61 | 6 7 |
| 1913 | 667 | 307 | 1,219 | 2,193 | 3,142 | 32 55 | 5 9 |
| 1917 | 1,039 | 410 | 1,713 | 3,162 | 2,691 | 26 34 | |
| 1920 | 5,735 | 636 | 2,840 | 9,211 | 5,779 | 55 99 | 12 5 |
| 1923 | 3,052 | 917 | 3,285 | 7,254 | 7,211 | 64 65 | 10 2 |
| 1927 | 3,345 | 1,335 | 4,367 | 9,067 | 9,504 | 80 41 | 11 3 |
| 1930 | 3,479 | 1,780 | 5,018 | 10,277 | 11,895 | 96 64 | 13 3 |
| 1933 | 1,793 | 1,505 | 4,210 | 7,508 | 11,393 | 90 73 | 17 7 |
| 1936 | 3,849 | 2,369 | 4,310 | 10,528 | 13,030 | 101 76 | 16 8 |
| 1939 | 5,416 | 3,571 | 4,303 | 13,286 | 17,232 | 131 66 | 18 7 |
| 1940 | 5,569 | 3,807 | 4,700 | 14,144 | 17,995 | 136 37 | 18 6 |
| 1941 | 7,673 | | | | | | |

¹ Calculated by dividing the figure for each year's expenditures by the corresponding index number of the United States Bureau of Labor Statistics wholesale price index

Derived from The Conference Board, *The Economic Almanac for 1941-42* (the Board, New York, 1941), pp. 360-361

stood at \$7,234,000,000. Federal tax receipts during the next seven years were held relatively level, while state and local receipts continued to increase. By 1930, total tax collections had reached a new peak—\$10,277,000,000. Three years of business recession carried the figure down to \$7,500,000,000 for 1933. Since then the move-

ment has been steadily and rapidly upward. By 1940, before federal defense taxes were registering any effect, total tax collections for the country exceeded \$14,000,000,000. The effect of the defense tax acts of 1940 and 1941 will be to raise the total tax bill of the country to around \$22,000,000,000 by 1942.

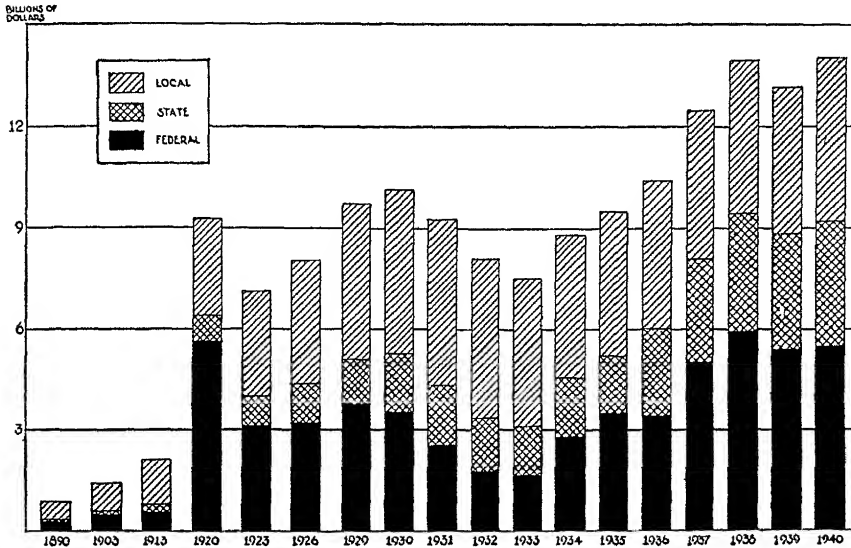


CHART VII: AMERICAN TAX REVENUES, 1890-1940

The tax burden

The "burden"² of a tax or of a total of tax collections is determined partly by the actual amount of tax revenue collected, and

² A growing number of fiscal writers criticize harshly the term and concept of "tax burden" (see C Lowell Harriss, "The Tax Burden and the National Income," *The Tax Magazine*, January 1938, pp 10-15). It carries, and frequently is intended to give, the implication that tax collections are dissipated by the governments that receive them, with no corresponding return to the community. Such implication, of course, is false. Part of the national income against which tax collections are measured is itself created by governmental expenditure. And the public benefits produced by governmental expenditure may far exceed the personal deprivations occasioned by tax payments.

But taxes do constitute a forced diversion of purchasing power and productive effort from voluntary personal determination. Directly or indirectly they restrict the sphere of personal disposal of income. In this limited sense they may be considered a "burden" on the individual and business community, and it is in this limited sense that the term "burden" is used in the discussion above. Our interest is in comparative tax "burdens" in different periods of time or as between different countries, rather than in the moderation or severity of the "tax burden" in one particular time and place.

partly by three other factors—changing price levels, increasing population, and changing national income. Tax collections rest more lightly on taxpayers in a period of high prices, when their money is worth less to them than in a period of low prices. Relative burden of a given tax collection depends, too, upon the number of taxpayers among whom this amount is divided—the larger their number, the less their individual payments. And finally, if the same amount of tax is collected at two different times from the same number of taxpayers, and if each taxpayer's income is larger on the second than on the first occasion, the burden of the second levy is lighter, since it absorbs a smaller proportion of each individual's purchasing power.

Prices having risen mildly between 1890 and 1913, the growth of American tax collections between these years was not so great, when measured by purchasing power, as the bare figures for tax receipts would indicate. During the next seven years prices more than doubled. Consequently, on a purchasing power basis, the tremendous tax collections of 1920 represent an increase of only 90 per cent over those of 1913, instead of the apparent 320 per cent increase indicated by bare receipt figures. Changing price level had no significant part in the tax story from 1921 through 1929. But from 1929 to 1933 prices fell faster than tax collections, so that in the latter year, at the depth of depression, American governments were actually taking a greater purchasing power from taxpayers than in 1929. Rising prices from 1933 to 1940 tended to offset somewhat the burden of increasing taxation.

Population has, of course, increased steadily from 1890 to the present. Per capita taxes, therefore, have risen less rapidly than collections, stated either in actual or "constant purchasing power" dollars. Allowing for cyclical variations, national income has grown even more rapidly than population. By this measure, the burden of American taxes after World War I was approximately double the pre-War tax burden. And during the recent depression and recovery periods, the burden of American taxes has been from a third to a half higher than that of the "normal" 1920's.

During the 1920's tax burdens in the United States were consid-

erably lower than in most other leading countries. The ratio of American taxes to national income during the 1920's varied between 10 and 13 per cent, while the ratio for England was 20 to 24 per cent, that for France 19 to 23 per cent, that for Germany 24 to 29 per cent, and that for Italy 19 to 20 per cent. During the 1930's, the tax burden in the United States apparently increased more rapidly than that of other leading countries. As compared with the American tax-to-national-income ratio of 21.9 per cent in 1938, the 1936-1937 ratio for England was 18.2 per cent, the 1938 ratio for France was 24.3 per cent, and the 1936-1937 ratio for Germany was 22.0 per cent.³ Subsequently, for all countries, war financing raised the ratios tremendously.

Political distribution of tax collections

Prior to the defense levies of 1940 and 1941, federal tax collections were normally about one-third of the country's total. But since income taxes predominated in the federal system, federal collections tended to vary more widely than state or local receipts. Thus federal tax collections in 1932 were only 22 per cent of the national total. Recovery and tax increases brought the proportion of federal taxes to more than 35 per cent for the second half of the decade. Defense taxes already enacted will probably carry the federal ratio for 1942 to over 60 per cent.

In this connection, it is interesting to note that during the 1930's, the United States had a lower ratio of federal to total taxes than any other country whose tax collection statistics are available. Only in Australia and Switzerland did the central government collect less than half of the total taxes. In England the ratio was over four-fifths.⁴

The American tax system

As shown in Tables 17 and 18, through the 1930's, at least, property taxes were the most important single item in the American tax system. In 1939 they were still the all-dominating element of local

³ Tax Research Foundation, *Tax Systems* (eighth edition), p. 364.

⁴ Tax Research Foundation, *op. cit.*, p. 360

TABLE 17
COMBINED AMERICAN TAX COLLECTIONS, 1938-1939

| Type of Tax | Amount (in millions) | | | | Per Cent of Total Revenue | | |
|-----------------------------|----------------------|---------|--------------------|----------|---------------------------|-----------------|-------|
| | Federal | State | Local ¹ | Total | Federal | State and Local | Total |
| Customs | \$319 | | .. | \$319 | 5 8 | .. | 2 3 |
| General sales | | \$440 | \$50 | \$490 | | 5 9 | 11 2 |
| Liquor ² | \$588 | 212 | . | 800 | 10 7 | 2 6 | 5 8 |
| Tobacco | 580 | 58 | | 638 | 10 6 | 7 | 4 6 |
| Other sales | 191 | 19 | | 210 | 3 5 | .2 | 1 5 |
| Total sales | \$1,359 | \$729 | \$50 | \$2,138 | 24 8 | 9 4 | 15 5 |
| Gasoline | \$207 | \$800 | \$2 | \$1,009 | 3 8 | 9 7 | 7 3 |
| Auto license | . | 384 | 1 | 385 | | 4 6 | 2 8 |
| Total highway | \$207 | \$1,184 | \$3 | \$1,394 | 3 8 | 14 3 | 10 1 |
| Property | . | \$190 | \$4,175 | \$4,365 | .. | 52 5 | 31 6 |
| Corporation income | \$1,116 | \$140 | | \$1,256 | 20 4 | 1 7 | 9 1 |
| Corporation franchise | 127 | 103 | \$ 1 | 231 | 2 3 | 1 3 | 1 7 |
| Utilities | 64 | 143 | 62 | 269 | 1 1 | 2 5 | 2 0 |
| Bank and insurance | .. | 103 | 1 | 104 | . | 1 3 | 7 |
| Stock and mortgage transfer | 36 | 26 | . | 62 | 7 | 3 | .5 |
| Miscellaneous licenses | | 31 | 49 | 80 | . | 1 0 | .6 |
| Other business | | 44 | | 44 | . | 5 | 3 |
| Total business | \$1,343 | \$589 | \$113 | \$2,045 | 24 5 | 8 6 | 14 9 |
| Payroll | \$740 | \$794 | \$7 | \$1,541 | 13 5 | 9 6 | 11.2 |
| Personal income . . | \$1,063 | \$209 | .. | \$1,272 | 19 4 | 2 5 | 9 2 |
| Death and gift | \$361 | \$132 | . | \$493 | 6 6 | 1 6 | 3 6 |
| Miscellaneous | \$93 | \$15 | \$110 | \$218 | 1 6 | 1.5 | 1.5 |
| Total taxes | \$5,485 | \$3,843 | \$4,457 | \$13,785 | 100.0 | 100.0 | 100 0 |

¹ Local figures represent yields of various fiscal years

² Does not include profits from state-owned liquor stores

Derived from Tax Research Foundation, *Tax Systems* (eighth edition), p. 315

TABLE 18

COMPARATIVE STRUCTURE OF TAX SYSTEMS OF
VARIOUS COUNTRIES, SECOND HALF OF 1930'S

| Type of Tax | United States | | Great Britain | | Canada | |
|---------------|---------------|-----------------|---------------|-------|----------|----------------------|
| | National | State and Local | National | Local | National | Provincial and Local |
| Customs | 2 3% | | 21 6% | . | 10 9% | |
| General sales | | 3 6% | | . | 19 8 | |
| Excises | 11 4 | 10 7 | 16 8 | | 6 0 | 7 6% |
| Property | | 31 6 | | 18 2% | | 34 3 |
| Business | 15 1 | 11 0 | | | | 5 2 |
| Income | 7 7 | 1 5 | 34 7 | . | 13 3 | |
| Death | 2 6 | 1 0 | 8 7 | .. | | 2 6 |
| Miscellaneous | 7 | 9 | 1 | | 3 | |
| Total . . | 39 8% | 60 2% | 81 8% | 18 2% | 50 3% | 49 7% |

| Type of Tax | France | | Germany | | Italy | |
|-----------------|----------|-------|----------|----------------------|----------|-------|
| | National | Local | National | Provincial and Local | National | Local |
| Customs | 15 5% | . | 8 5% | . | 7 8% | .. |
| General sales | 14 0 | . | 11 4 | 3 7% | 7 4 | . |
| Excises . . | 16.5 | 5 2% | 13 0 | 3 7 | 19 5 | 3 9% |
| Property . . | | 14 6 | 2 3 | 15 5 | 3 0 | 9 |
| Business . . | 7 3 | 1 | 3 7 | 7 0 | 11 4 | .. |
| Income . | 21 9 | . | 17 1 | 13 1 | 19 0 | .6 |
| Death | . | .. | 5 | .. | 5.2 | . |
| Miscellaneous . | .. | 4 9 | .5 | .. | 20.3 | 9 |
| Total . . | 75 2% | 24 8% | 57.1% | 42 9% | 93 7% | 6 3% |

Derived from Tax Research Foundation, *Tax Systems* (eighth edition), p 360

finance They produced over 50 per cent of combined state and local tax revenue, and slightly over 30 per cent of combined federal, state, and local tax receipts. In European countries where property taxes were imposed during the 1930's, the ratio was commonly between 10 and 20 per cent; many countries did not levy such taxes at all.

Sales taxes and commodity and service excises, which ranked next to property taxes in the American tax system in 1938-1939, yielded over 15 per cent of the total revenue. Of the \$2,100,000,000 produced

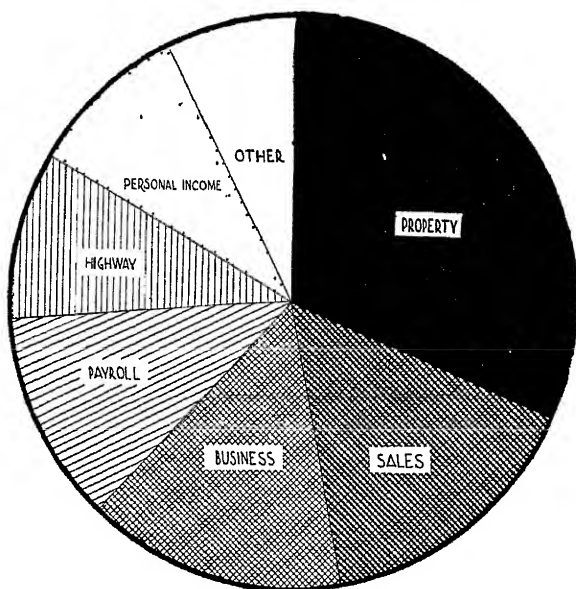


CHART VIII SOURCES OF AMERICAN TAX REVENUE, 1938-1939

by these taxes, \$1,440,000,000 came from liquor and tobacco taxes. If gasoline taxes and motor vehicle licenses are included in the classification, this group of consumption taxes accounted for one quarter of the country's tax revenue. With the exception of Great Britain, other countries placed even more dependence on these consumption levies than did the United States.

Business taxes accounted for another 15 per cent of American tax revenue. The major item in this classification was the billion dollar

federal corporation income tax. No other important country has developed this field of taxation as extensively as has the United States. Payroll taxes to finance social security expenditures have recently become a major element in the American tax system. The \$1,500,000,000 collected from this source in 1938-1939 was nearly one-quarter more than the yield of the combined federal and state personal income taxes. In general, during the 1930's, the personal income tax played a far smaller role in the American tax system than in the system of any other great nation.

The "defense" levies imposed by the federal revenue acts of 1940 and 1941 will change this picture considerably. The substantial increase over 1940 federal corporation tax payments which the excess profits tax and the increase in the corporation income tax rates are expected to produce will enhance considerably the proportion of revenue derived from business taxation. The personal income tax and, to a lesser extent, the commodity tax group, will occupy a more important position as a consequence of the new federal defense taxes. Property tax receipts will probably not decline, but their proportion of the country's total tax revenue will fall considerably during the next few years.

DEVELOPMENT OF THE FEDERAL TAX SYSTEM

The tax history of the federal government falls into three broad periods—from 1790 to 1860, from 1860 to 1910, and from 1910 to the present. Emergency taxes levied during the Civil War, the Spanish War, and World War I were temporary phenomena, dropped as soon as the pressure for war revenues was past.

Pre-Civil War period

Prior to the Civil War, the federal government depended primarily on customs duties for its tax revenue. Minor excises and an apportioned "direct tax" levied during the 1790's were abolished in Jefferson's first administration. A new series of excises and another "direct tax" were imposed in 1813 to provide war revenues and were continued for only four years. In but one year before the Civil War—1815—did internal revenue exceed 50 per cent of the

customs yield, and for the period as a whole the ratio of internal to customs revenue was infinitesimal.

Civil War and postwar period

Before the close of the Civil War, the federal government was exploiting every source of tax revenue that the ingenuity of Congress and the Treasury officials could devise. A direct tax was levied on real property and apportioned among the loyal states in 1861,

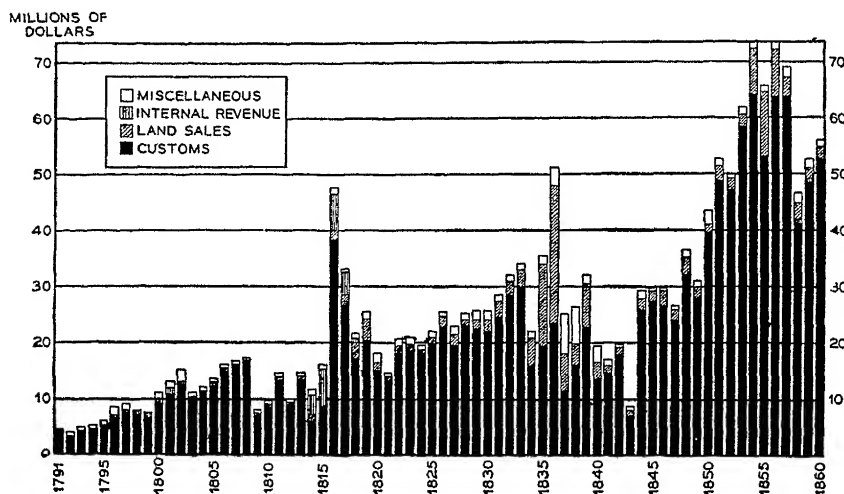


CHART IX SOURCES OF FEDERAL REVENUE, 1791-1860

but it proved ineffective and was soon indefinitely suspended. Resort was had to a personal income tax, to an inheritance tax, to an excise on spirituous and fermented liquors, to a bank tax, to gross receipts taxes on railroads, insurance companies, and other corporations, to a general sales tax on manufactured articles and products, to stamp taxes on articles and documents, and to license and special taxes on particular occupations. With this hodgepodge of impositions, federal internal revenue collections exceeded customs duties in the fiscal year 1864—for the first time in the history of federal taxation.

Repeal of the "war taxes" was begun in 1866, and continued

through the next six years. Only a bank tax, a tobacco excise, and a liquor excise remained after 1872. Federal internal revenue declined from the peak of \$311,000,000 in 1866 to little more than \$100,000,000 in 1873. Customs duties again became the main source of federal revenue.

1873-1909

Throughout the late 1870's and the 1880's, considerable difficulty was experienced in balancing federal expenditures and revenues—

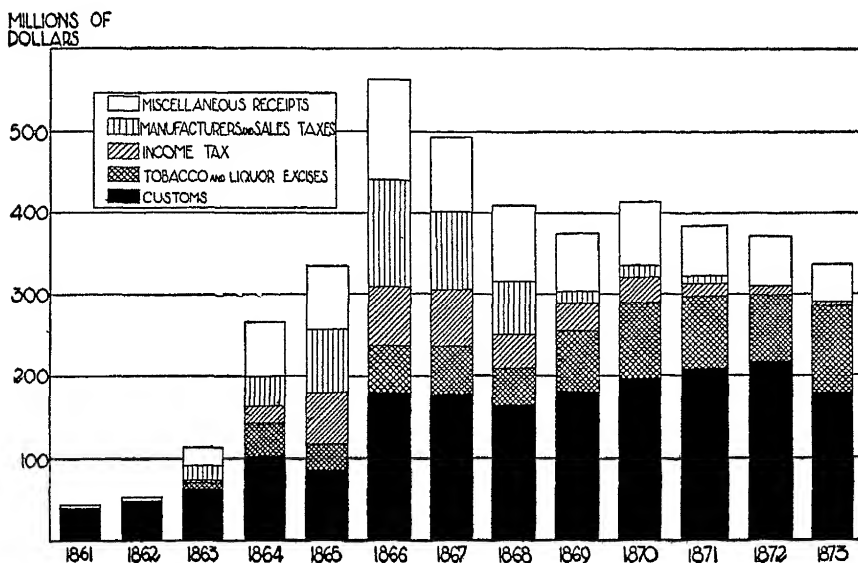


CHART X. SOURCES OF FEDERAL REVENUE, 1861-1873

receipts from existing taxes persistently exceeded expenditures. Congress refused to lower the customs duties, since "protection" would thereby be sacrificed. Internal revenues were cut instead. The federal bank tax was abolished in 1883, and tobacco and liquor excise rates were cut several times.

Depression solved the problem of the federal surplus in the 1890's, and when in 1894 the Democrats cut the tariff schedule, they sought to replace the lost revenue by a combined personal income and inheritance tax. But the Supreme Court construed this levy as a

"direct tax" and therefore invalid, since it was not apportioned among the states according to population⁵ Stamp taxes, special occupation taxes, special sales taxes, and an inheritance tax were enacted in 1898 to provide revenues for the Spanish War. By 1902, the need for them having passed, all had been repealed. Once again the federal internal revenue system was reduced to the tobacco and liquor excises, and customs duties furnished the greater part of federal revenue.

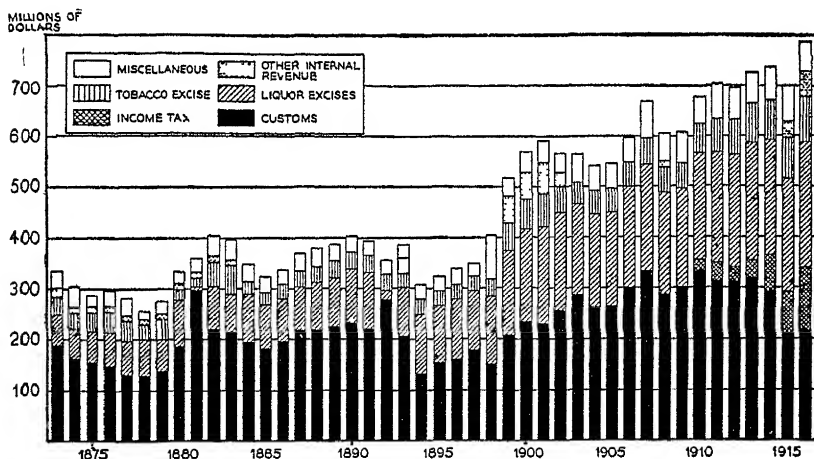


CHART XI. SOURCES OF FEDERAL REVENUE, 1873-1916

Since 1909

A new fiscal era for the federal government was ushered in by the enactment of the Corporation Excise of 1909—a one per cent income tax on corporations. For the first time, with the exception of the invalid income and inheritance tax of 1894, the federal government was levying a noncommodity tax in peace times. Other noncommodity taxes followed in rapid succession. Ratification of the Sixteenth Amendment permitted the levy of a personal income tax in 1913. An estate tax was imposed in 1916.

All existing rates were increased and many new taxes were levied when the United States entered World War I. Among the new taxes were an excess profits tax and a war profits tax to supplement

⁵ *Pollock v Farmers Loan & Trust Co.*, 157 U S (1895) 429, 158 U S (1895) 601

TABLE 19
SOURCES OF FEDERAL TAX REVENUE, SELECTED FISCAL YEARS 1863-1940¹

| Fiscal Year | Customs Duties | Liquor and Tobacco Excises | Other Commodity and Service Taxes | Personal Income Tax | Corporation Income Tax | Other Business Taxes | Death and Gift Taxes | Payroll Taxes | Miscellaneous | Total |
|--------------------------------|----------------|----------------------------|-----------------------------------|---------------------|------------------------|----------------------|----------------------|---------------|---------------|---------|
| <i>Amount (in millions)</i> | | | | | | | | | | |
| 1863 | \$ 69.1 | \$ 9.9 | \$ 4.2 | \$ 2.7 | | \$ 23.0 | \$ 3.1 | | \$ 1.1 | 110.1 |
| 1870 | 194.5 | 93.3 | 24.4 | 37.8 | | 24.0 | 3.1 | | 1.8 | 378.8 |
| 1880 | 186.5 | 112.9 | 7.1 | . | | 3.6 | | | 4 | 310.5 |
| 1890 | 229.7 | 141.7 | .8 | | | | | | 1 | 372.3 |
| 1900 | 233.2 | 242.8 | 43.8 | | | 5.6 | 2.9 | | 2 | 528.5 |
| 1910 | 333.7 | 266.7 | 1.7 | | \$ 21.0 | | | | 2 | 623.6 |
| 1920 | 322.9 | 435.7 | 724.1 | \$3,956.9 | | 173.7 | 103.6 | | 6 | 5,730.4 |
| 1930 | 587.0 | 462.0 | 28.7 | 1,146.8 | 1,263.4 | 72.9 | 64.8 | | 1.4 | 3,627.0 |
| 1940 | 348.6 | 1,232.7 | 584.8 | 982.0 | 1,139.1 | 208.1 | 359.9 | \$833.5 | | 5,688.7 |
| <i>Percentage Distribution</i> | | | | | | | | | | |
| 1863 | 62.8 | 9.0 | 3.8 | 2.5 | | 20.9 | 1 | | 1.0 | 100.0 |
| 1870 | 51.4 | 24.6 | 6.5 | 10.0 | | 6.3 | 8 | | 5 | 100.0 |
| 1880 | 60.1 | 36.4 | 2.3 | | | 1.2 | .. | | 1 | 100.0 |
| 1890 | 61.7 | 38.1 | 2 | . | | | .. | | | 100.0 |
| 1900 | 44.1 | 45.9 | 8.3 | | | 1.1 | .5 | | | 100.0 |
| 1910 | 53.5 | 42.8 | 3 | | 3.4 | | | | 1 | 100.0 |
| 1920 | 5.6 | 7.6 | 12.6 | 69.1 | | 3.0 | 1.8 | | 2 | 100.0 |
| 1930 | 16.2 | 12.7 | 8 | 31.6 | 34.8 | 2.0 | 1.8 | | 4 | 100.0 |
| 1940 | 6.1 | 21.7 | 10.3 | 17.3 | 20.0 | 3.7 | 6.3 | 14.6 | | 100.0 |

¹ Customs duties on basis of warrants issued, internal revenue on basis of collections

Derived from United States Secretary of the Treasury, *Annual Reports*

the corporation income tax, a tax on all forms of transportation, a tax on insurance companies, a multitude of special commodity and production taxes including excises on the sale of automobiles, musical instruments, jewelry, sporting goods, cameras and moving picture films, cosmetics, toilet articles, medicines, chewing gum, theater admissions and club dues, and a series of stamp taxes. It is significant that in 1919 customs duties provided only 4.6 per cent and liquor and tobacco excises only 17.1 per cent of federal tax revenue;

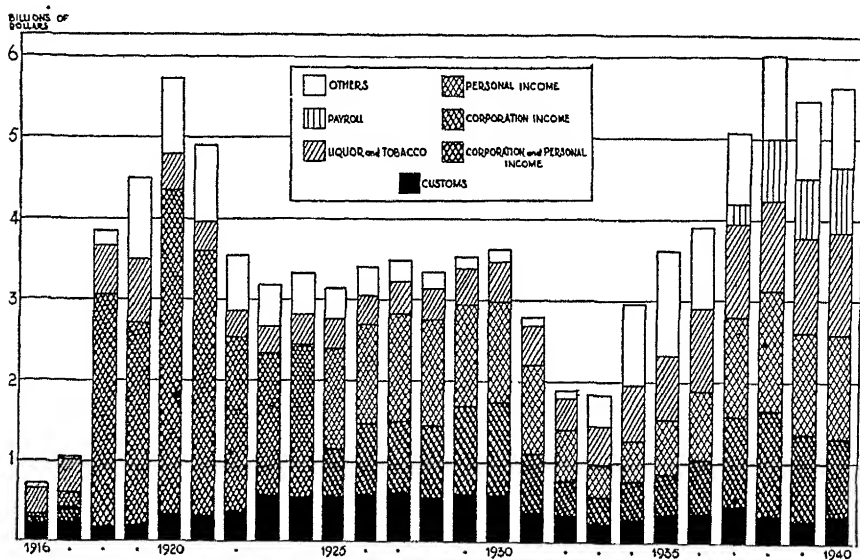


CHART XII SOURCES OF FEDERAL TAX REVENUE, 1916-1940

64.5 per cent was derived from the combined personal income, corporation income, and excess profits tax.

During the 1920's the excess profits tax, the transportation tax, the insurance tax, and the special excises on commodities and occupations were abolished. Except for a small fraction, the excise on spirituous liquors was, of course, lost with the advent of Prohibition. The income tax on persons and corporations and the estate tax, levied before the United States entered the War, were retained at lowered rates. Some war stamp taxes, the customs duties, and the tobacco excise were also continued as sources of federal revenue. In 1930 the corporation income tax accounted for 34.8 per cent, the

personal income tax for 31.6 per cent, customs duties for 16.2 per cent, and the tobacco excise for 12.5 per cent of the federal tax revenue.

Depression and recovery changed the setup of the federal revenue system. All tax revenues fell off between 1930 and 1933, but none so markedly as the highly elastic income tax. In 1930 this tax produced over \$2,400,000,000, in 1933 only \$750,000,000. In the former year it had contributed 65 per cent of the federal tax revenues; in the latter year the proportion was only 40 per cent. Business recovery, higher rates for existing taxes, and several new taxes restored federal tax revenues by 1935 to the predepression level, and subsequently carried them well above the 1930 peak, though they never remotely achieved a balance with expenditures during these years. Personal exemptions of the personal income tax were lowered in 1932; and the surtax rate schedule was substantially increased in 1932, 1934, and 1935. Corporation tax burdens were increased in one way or another in almost every year of the decade—the corporation income tax rate was increased in 1932; a combined capital stock and excess profits tax was imposed in 1933; all of the corporation tax rates were raised in 1935; an undistributed profits tax was imposed in 1936, reduced in 1938, and abolished in 1939, but with an increase of corporation income tax rates on each occasion. Estate tax rates were increased in 1932, 1934 and 1935, making this tax for the first time a major revenue producer for the federal government. Most important of the new taxes, from a fiscal point of view, were the liquor excises imposed in 1934 after the repeal of the Eighteenth Amendment, the cent-a-gallon gasoline tax levied in 1932, the short-lived AAA processing taxes enacted in 1933 and outlawed by the Supreme Court in 1936, and the social security payroll taxes provided by the Social Security Act of 1935. The yields of the gasoline tax, liquor excises, and payroll tax expanded steadily, and by 1940 accounted for over 30 per cent of the federal tax revenue.

Except for the addition of the excess profits tax to the group of corporation taxes, the "defense" revenue acts of 1940 and 1941 did not change the general character of the federal tax system. The additional revenue needed for armament was derived mainly from

TABLE 20
FEDERAL INTERNAL REVENUE RECEIPTS,
SELECTED FISCAL YEARS 1930-1940

| Tax or Tax Group | 1930 | 1932 | 1934 | 1936 | 1938 | 1940 |
|---|---------|---------|---------|---------|---------|---------|
| <i>Amount (in millions)</i> | | | | | | |
| Individual income | \$1,147 | \$ 427 | \$ 470 | \$ 675 | \$1,286 | \$ 982 |
| Corporation | 1,263 | 630 | 481 | 849 | 1,476 | 1,272 |
| Estate and gift | 65 | 47 | 113 | 379 | 417 | 360 |
| Liquor | 13 | 9 | 259 | 505 | 568 | 624 |
| Tobacco products | 450 | 399 | 425 | 501 | 568 | 609 |
| Gasoline and auto | 2 | | 299 | 299 | 325 | 377 |
| Agricultural aid and other control | . | .. | 371 | 102 | 68 | 104 |
| Social security | | . | . | a | 743 | 834 |
| Other | 100 | 46 | 254 | 211 | 207 | 184 |
| Total | \$3,040 | \$1,557 | \$2,672 | \$3,520 | \$5,659 | \$5,346 |
| <i>Percentage of Total Tax Revenue, Including Customs</i> | | | | | | |
| Individual income | 31.6 | 22.6 | 15.7 | 17.3 | 21.4 | 17.2 |
| Corporation | 34.8 | 33.4 | 16.1 | 21.7 | 24.5 | 22.3 |
| Estate and gift | 1.8 | 2.5 | 3.8 | 9.7 | 6.9 | 6.4 |
| Liquor | 4 | 5 | 8.7 | 12.9 | 9.4 | 10.9 |
| Tobacco products | 12.4 | 21.2 | 14.2 | 12.8 | 9.4 | 10.7 |
| Gasoline and auto | .1 | | 10.0 | 7.7 | 5.4 | 6.7 |
| Agricultural aid and other control | | .. | 12.4 | 2.6 | 1.1 | 1.8 |
| Social security | | . | . | a | 12.3 | 14.6 |
| Other | 2.8 | 2.4 | 8.5 | 5.4 | 3.4 | 3.3 |
| Total | 83.8 | 82.6 | 89.4 | 90.1 | 94.0 | 93.8 |

a. Less than \$500,000

Derived from United States Secretary of the Treasury, *Annual Reports*

increases in the rates of the existing taxes. Personal exemptions in the personal income tax were again lowered, and the rates were substantially sharpened. Besides the superimposition of the excess profits tax, all corporation tax rates were increased. Rates of the

estate and gift taxes, the liquor taxes, the tobacco taxes, the gasoline taxes, and various other excises were increased. Some new excises were levied, but the broadening of the field of federal commodity and service taxation was slight. Popular and expert opinion recommended heavy regulatory excises to discourage purchases of automobiles, refrigerators, rubber goods, and other items whose production for civilian use competed with defense demands, but Congress exhibited only lukewarm interest in the idea. New taxes were imposed or pre-existing rates on these products were raised, but in no case was the added tax burden substantial enough to exercise any controlling influence over purchasing demand.

DEVELOPMENT OF STATE TAX SYSTEMS

For the American colonies under English rule, land and poll taxes, liquor excises, and customs and tonnage duties were the primary sources of revenue. When they became states in the federal union, they were forbidden by the federal Constitution to levy customs or tonnage duties. The land tax, expanded into the general property tax, became their basic fiscal support. During the nineteenth century, some states tapped other sources of tax revenue—special bank taxes, insurance company taxes, railroad taxes, general corporation taxes, and inheritance taxes—but nowhere did these supplementary levies produce more than a small fraction of total state income.

More and more, however, toward the close of the century, the states came to rely on levies other than the general property tax. In the twentieth century this tendency accelerated. Corporation taxes became increasingly prominent during the first two decades, and motor vehicle license taxes and gasoline taxes moved to the fore after 1920. Property taxes still produced one-third of the state revenues in 1925, but by 1930 the proportion was under one-fifth, and by 1940 it was down to one-sixteenth. By that time, thirteen states had relinquished altogether the property tax as a source of state revenue. In occasional states, however, property taxes remained an important element of state revenue; in Arizona and Nevada they constituted one-fourth of the state governments' tax receipts, and

TABLE 21
SOURCES OF STATE TAX REVENUE, SELECTED YEARS 1915-1940

| Year | General and Selected Property Taxes | Corporation and Personal Income Taxes | Death Taxes | Payroll Taxes | Liquor Taxes ¹ | Tobacco Products Taxes | General Sales Taxes | Motor Vehicle Licenses | Gasoline Taxes | All Other Taxes | Total |
|--------------------------------|-------------------------------------|---------------------------------------|-------------|---------------|---------------------------|------------------------|---------------------|------------------------|----------------|-----------------|----------|
| <i>Amounts (in millions)</i> | | | | | | | | | | | |
| 1915 ^a | \$185.9 | \$ 5 | \$ 28.8 | | \$ 20.8 | ° | . | ° | ° | \$129.7 | \$ 365.5 |
| 1919 ^a | 237.2 | 26.5 | 45.8 | . | 14.2 | ° | . | ° | ° | 204.1 | 527.8 |
| 1925 ^a | 358.6 | 60.5 | 85.9 | . | | ° | . | \$198.7 | \$ 87.4 | 316.2 | 1,107.4 |
| 1930 ^a | 345.2 | 128.4 | 180.8 | . | | \$10.5 | \$ 1.2 | 296.4 | 399.5 | 411.4 | 1,780.3 |
| 1932 ^a | 320.4 | 84.2 | 143.0 | . | | 17.6 | 1.1 | 265.8 | 415.6 | 378.5 | 1,619.3 |
| 1937 ^a | 254.3 | 304.2 | 114.9 | \$346.8 | 174.3 | 54.1 | 431.0 | 309.5 | 649.3 | 467.0 | 3,105.4 |
| 1937 ^b | 291.9 | 355.9 | 115.9 | 346.8 | 221.2 | 54.4 | 434.4 | 349.1 | 721.8 | 468.9 | 3,360.3 |
| 1938 ^b | 244.0 ^c | 383.2 | 141.9 | 701.6 | 226.3 | 55.4 | 446.8 | 358.8 | 777.2 | 498.9 | 3,834.0 |
| 1939 ^b | 259.2 | 333.7 | 133.0 | 799.0 | 227.8 | 59.5 | 440.1 | 363.5 | 800.9 | 467.2 | 3,884.0 |
| 1940 ^b | 264.7 | 357.9 | 117.9 | 843.6 | 259.6 | 97.1 | 490.2 | 387.7 | 845.4 | 506.8 | 4,170.8 |
| <i>Percentage Distribution</i> | | | | | | | | | | | |
| 1915 ^a | 50.9 | 1 | 7.9 | . | 5.7 | ° | . | ° | ° | 35.5 | 100.0 |
| 1919 ^a | 44.9 | 5.0 | 8.7 | . | 2.7 | ° | . | ° | ° | 38.7 | 100.0 |
| 1925 ^a | 32.4 | 5.5 | 7.8 | . | | ° | ° | 17.9 | 7.9 | 28.6 | 100.0 |
| 1930 ^a | 19.5 | 7.2 | 10.2 | . | | 6 | 1 | 16.7 | 22.5 | 23.2 | 100.0 |
| 1932 ^a | 19.7 | 5.2 | 8.7 | 11.2 | 5.6 | 1.1 | 1 | 16.3 | 25.6 | 23.3 | 100.0 |
| 1937 ^a | 8.2 | 9.8 | 3.7 | | | 1.7 | 13.9 | 10.0 | 20.9 | 15.0 | 100.0 |
| 1937 ^b | 8.7 | 10.6 | 3.4 | 10.3 | 6.6 | 1.6 | 12.9 | 10.4 | 21.5 | 14.0 | 100.0 |
| 1938 ^b | 6.4 | 10.0 | 3.7 | 18.3 | 5.9 | 1.4 | 11.7 | 9.4 | 20.3 | 13.0 | 100.0 |
| 1939 ^b | 6.7 | 8.6 | 3.4 | 20.6 | 5.9 | 1.5 | 11.3 | 9.4 | 20.6 | 12.0 | 100.0 |
| 1940 ^b | 6.3 | 8.6 | 2.8 | 20.7 | 6.2 | 2.3 | 11.8 | 9.3 | 20.7 | 12.2 | 100.0 |

¹ Includes liquor license revenue

^a Excludes local shares

^b Includes local shares

^c Included in "all other taxes"

Derived from U. S. Bureau of the Census, *State and Local Tax Collections, 1840, p. 29*

in Maine, Nebraska, and Utah the proportion was only slightly lower.

The two taxes that now share top honors in the state revenue systems are the gasoline tax and the payroll tax. Each of these taxes produced slightly under \$850,000,000 in 1940, and between

TABLE 22
PERCENTAGE DISTRIBUTION OF SOURCES OF STATE TAX
REVENUE IN PARTICULAR STATES, 1939

(Payroll Taxes Excluded)

| | All States | De- la- ware | Ne- braska | New York | Okla- homa | Ver- mont | West Vir- ginia | Wyo- ming |
|----------------------------|---------------|--------------------|---------------|-------------|---------------|--------------|-----------------------|--------------|
| Gasoline | 26 1 | 21 9 | 50 0 | 16 1 | 25 9 | 24 4 | 22 1 | 27 5 |
| General sales | 14 4 | | | | 19 3 | | 47 8 | 19 9 |
| Motor vehicle | 12 6 | 11 6 | 9 7 | 11 3 | 14 7 | 23 5 | 12 8 | 7 1 |
| Net income | 11 5 | 11 3 | . | 34 7 | 12 8 | 6 8 | 3 0 | |
| Alcoholic bev- erages | 6 9 | 7 1 | 7 1 | 10 4 | 1 7 | 20 0 | 2 5 | 3 5 |
| Property | 6 2 | . | 23 6 | . | . | . | 1 7 | 7 6 |
| Death and gift | 4 3 | 2 6 | 3 | 8 5 | 1 0 | 3 0 | 1 6 | 5 |
| Utility | 4 7 | 1 7 | 3 | 4 1 | . | 7 7 | 1 7 | 25 4 |
| Franchise | 3 4 | 34 5 | 1 1 | 7 3 | 1 2 | 8 | 1 6 | 2 |
| Insurance | 2 8 | 2 5 | 2 5 | 4 | 2 0 | 3 2 | 2 1 | 1 9 |
| Tobacco | 1 9 | . | . | 2 | 3 9 | 3 4 | | |
| Severance | 1 5 | | | | 17 2 | | | 6 4 |
| License | 1 0 | 2 4 | 1 0 | .. | .. | 1 7 | 2 0 | .. |
| Admission and amusement | | 3 1 | | 3 | . | .. | . | |
| Poll | | .. | 4 0 | .. | .. | | 8 | |
| Bank | 2 7 | 9 | .. | 1 1 | . | 5 4 | .1 | . |
| Stock transfer | | | .. | 5 4 | . | | . | .. |
| Other | | 4 | .4 | 2 | .3 | 1 | 2 | |
| Total | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 | 100 0 |

Derived from *Tax Policy*, Vol VII, No 8, June 1940, pp. 2, 3.

them accounted for over two-fifths of the states' tax revenues. Payroll and gasoline taxes are imposed in every state. Two other state taxes that have assumed importance in recent years are the general sales tax, levied either as a retail sales tax or as a general excise, and the liquor taxes imposed as license charges on producers and dealers

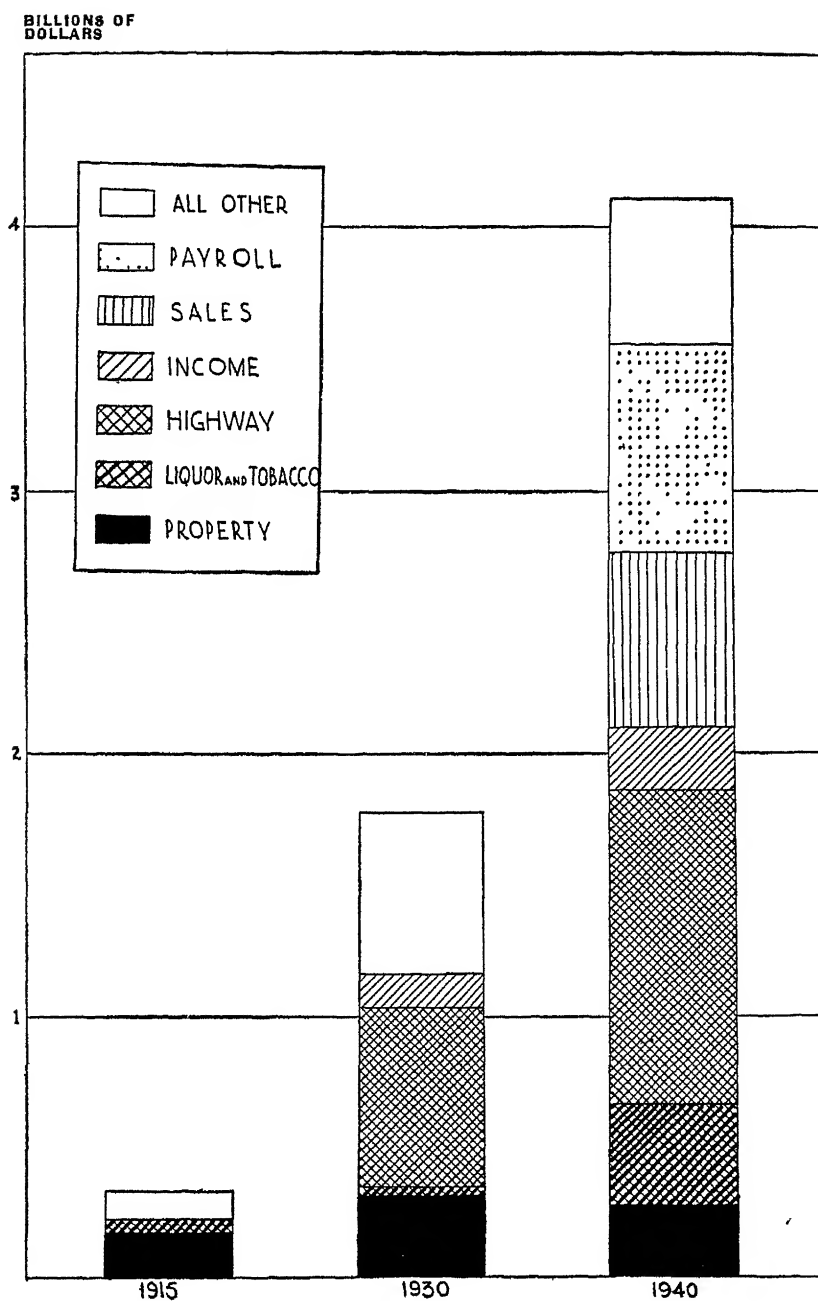


CHART XIII: SOURCES OF STATE TAX REVENUE, 1915, 1930, 1940

and as excises on liquor sales. The twenty-three states employing general sales taxes in 1940 obtained nearly \$500,000,000 from this source. Liquor taxes yielded over \$250,000,000. Motor vehicle license charges, their yield slowly but steadily rising, now produce close to \$400,000,000 annually.

Although thirty-six states levy personal income taxes, or corporation income taxes, or both, the yield of these taxes is far below that of state gasoline taxes, payroll taxes, automobile license charges, or general sales taxes. Through the later 1930's, state income taxes yielded around \$350,000,000 annually, between 8 and 10 per cent of the states' tax revenue. Inheritance and estate taxes, though imposed by all states but one, constitute only a minor element of the state tax system.

LOCAL TAX REVENUES

Property taxes have always been the all-important source of local revenue. Of the \$4,457,000,000 of local tax collections reported for 1938-1939, \$4,175,000,000 was derived from property taxes. In some states the yield of certain state-collected taxes—motor vehicle license and fuel taxes, personal income taxes, inheritance taxes, corporation taxes, sales taxes, and others—is divided between the state and the local governments.⁶ But these "shared" taxes, although they constitute a substantial item of local revenue in some states—New York local governments received \$63,600,000 from shared taxes in the 1940 fiscal year—are relatively unimportant for the country as a whole, when compared with local property tax receipts. Most cities and some counties derive some revenue from local licenses and permits; foremost are the recently restored liquor license taxes. And a very few local governments obtain income from special gasoline taxes, automobile license charges, chain store taxes, and sales taxes.

SOCIAL AND ECONOMIC DISTRIBUTION OF TAX BURDENS

Many are the generalizations made about the social and economic incidence of the American tax system. Spokesmen for the richer

⁶ See pp 727 ff of this volume.

TABLE 23
TAX BURDENS ON INDIVIDUALS, BY ECONOMIC GROUPS AND INCOME CLASSES, 1936

| Income Received ¹ | Farmer | | | Wage Earner | | Mer- chant | Salaried Worker | | Corporation Official |
|---|--------|--------|--------|-------------|--------|---------------|-----------------|----------|-------------------------|
| | \$500 | \$1000 | \$2000 | \$1000 | \$2000 | \$5000 | \$5000 | \$20,000 | \$100,000 |
| <i>New York Family</i> | | | | | | | | | |
| Federal taxes | \$ 7 | \$ 14 | \$ 25 | \$ 30 | \$ 50 | \$ 254 | \$ 300 | \$3,999 | \$ 872,315 |
| State taxes | 9 | 26 | 44 | 35 | 57 | 350 | 201 | 2,059 | 194,161 |
| Local taxes | 44 | 69 | 126 | 116 | 227 | 560 | 560 | 1,401 | 48,120 |
| Total taxes | \$60 | \$109 | \$195 | \$181 | \$334 | \$1,164 | \$1,061 | \$7,459 | \$1,114,597 |
| Per cent of potential income ¹ | 12 0 | 10 9 | 9 8 | 18 6 | 17 2 | 23 9 | 20 8 | 31 6 | 44 3 |
| <i>Illinois Family</i> | | | | | | | | | |
| Federal taxes | \$ 9 | \$ 18 | \$ 32 | \$ 35 | \$ 59 | \$ 288 | \$ 342 | \$4,438 | \$ 956,727 |
| State taxes | 16 | 35 | 58 | 53 | 86 | 182 | 167 | 511 | 30,292 |
| Local taxes | 31 | 51 | 93 | 102 | 214 | 544 | 544 | 1,342 | 47,250 |
| Total taxes | \$56 | \$104 | \$183 | \$190 | \$359 | \$1,014 | \$1,053 | \$6,291 | \$1,034,269 |
| Per cent of potential income ¹ | 11 2 | 10 4 | 9 2 | 19 3 | 18 2 | 20 6 | 20 5 | 27 2 | 38 4 |

¹ "Potential income" equals "income received" plus business taxes which reduce the amount of business earnings accruing to individuals as income

Derived from Twentieth Century Fund, *Facing the Tax Problem* (New York 1937), pp 230-232

ments, as we have previously seen, depend to a considerable extent upon property taxes, sales taxes, and forms of business taxation that are shifted, sometimes wholly and sometimes partly, through higher prices into consumption expenditure; since such expenditure absorbs a major fraction of the incomes of the poor, these "concealed" tax burdens bear heavily upon them. Incomes above the \$3000 level felt the impact of the progressive federal personal income tax and of the non-shiftable business taxes which burden investment income. For incomes over \$5000, the major tax burden was that imposed by

TABLE 24
PERCENTAGE THAT TAXES WERE OF INCOME IN NEW YORK
AND ILLINOIS, BY INCOME CLASSES, 1936¹

| Median Income Received ² | New York | | | | | Illinois | | | |
|---|----------|--------|---------|-----------------|-----|----------|-----|-----|-----|
| | I | II-III | | | IV | I | II | III | IV |
| | | Total | Federal | State- local | | | | | |
| \$ 500 | 15 | 16 | 4 | 12 | 21 | 14 | 14 | 16 | 17 |
| 1,000 | 16 | 14 | 4 | 10 | 17 | 17 | 14 | 14 | 16 |
| 1,500 | 16 | 14 | 4 | 10 | 15 | 17 | 13 | 13 | 15 |
| 2,000 | 16 | 13 | 4 | 9 | 16 | 17 | 13 | 13 | 15 |
| 2,800 | 19 | 13 | 4 | 9 | 16 | 17 | 16 | 15 | 18 |
| 5,000 | 22 | 20 | 10 | 10 | 23 | 21 | 31 | 26 | 33 |
| 10,000 | 24 | 24 | 14 | 10 | 28 | 25 | 28 | 32 | 28 |
| 20,000 | 37 | 38 | 29 | 9 | 40 | 32 | 31 | 37 | 33 |
| 37,000 | 39 | 42 | 34 | 8 | 44 | 35 | 34 | 38 | 36 |
| 65,000 | 43 | 47 | 38 | 9 | 47 | 40 | 38 | 42 | 41 |
| 200,000 | 68 | 58 | 48 | 10 | 60 | 58 | 60 | 67 | 53 |
| 600,000 | 76 | 76 | 68 | 8 | 77 | 79 | 80 | 75 | 68 |
| 1,000,000 | 111 | 115 | 104 | 11 | 118 | 103 | 106 | 117 | 108 |

¹ Some assumptions had to be made about the shifting and incidence of the taxes involved. Since the incidence of the incidence theories, it seemed advisable to work out four independent calculations. In many different shifting and incidence assumptions, these are indicated in the table by the Roman numerals. It will be noted that while there is variation in the particular percentages arrived at on the basis of these different shifting and incidence assumptions, they all present the same general picture.

² Since "income received" does not include income which would have been received had not business taxes absorbed it before it reached the business owners, it is possible for taxes on large incomes to exceed income actually received.

Based on calculations from figures in Robert B. Pettengill, "Tax Burden Among Income Groups," *American Economic Review*, March 1940, pp. 60-71, which in turn are based on figures from Twentieth Century Fund, *Facing the Tax Problem* (New York, 1937), pp. 230-232.

federal levies, and this burden mounted progressively through the higher ranges of income.

Farm tax burden

During the 1920's the federal Department of Agriculture, the state agricultural experiment stations, and other agencies issued statistics purporting to show that the farmers were bearing a disproportionately heavy tax burden. "Farm profits" were calculated by subtracting a wage allowance for the labor of the farmer and his family, and farm taxes were calculated in relation to this "farm profit." According to this calculation, farm taxes absorbed between 30 and 40 per cent of farm profits, a ratio apparently indicating a crushing tax burden⁷

But if "farm tax burdens" and the tax burdens on other economic groups are to be compared, the earnings attributed to the farmer for his and his family's labor should be counted as much a part of "farm income" as his "profit" or "investment" earnings. A calculation of the ratio of farm taxes to the net income of operator-owned farms from 1923 to 1935 shows a low of 6.5 per cent in 1925, a high of 20.3 per cent in 1932, and another low of 6.3 per cent in 1935—which gives a very different impression of farm tax burden from that derived from the "farm profits" calculation.

Neither the "farm profits" nor the "farm income" calculations of farm tax burden, however, take tax shifting into account. Some part of the taxes paid directly by farmers is unquestionably shifted into the prices of farm products. And farmers as consumers, like all other population groups, bear a hidden burden of taxes shifted to them through the prices of their purchases. When tax shifting is taken into account, we come to the situation disclosed by the Twentieth Century Fund calculations—measured by income, the farmers' tax burden is considerably lighter than that borne by other economic groups.

To estimate that a farmer with a \$10,000 farm and a \$2,000 income pays out less than ten per cent of that income in taxes, however, is somewhat ironical if the farmer is not earning \$2,000, or even \$1,000,

⁷ The first edition of this work presented this "official" interpretation

or even \$500. And this was the situation of millions of farmers in various sections of the country during the 1920's and early 1930's. After the wages of the hired help, and the interest on mortgages incurred during the false prosperity of the war period, and county, school, and special district taxes had been paid, what remained from the sale of a season's crops provided bare subsistence for the farmers' families—or even less, and the farmers sank still further into debt. Under such circumstances, any tax payments were certain to be felt as a crushing burden. And property tax rates, and hence farm tax payments, were slowly but inexorably rising during this period.

Fundamentally, this is not a problem of Public Finance, but of Agricultural Economics. When means were found of restoring a measure of prosperity to the depressed farm areas, the tax payments previously considered such a crushing burden became quite bearable. It is significant that during the farm "recovery" of the second half of the 1930's, complaints about the "burden" of farm taxes diminished, although rural property tax rates declined little.

Whether or not the argument that farmers have been carrying an undue tax burden is sound, it played an important part in state and local tax developments for the twenty years after 1920. The revenue pressure of rural local governments on the general property tax—the main element in the farmers' tax burden—was relieved by shifting such locally exercised functions as education, road construction and maintenance, and social welfare, to state governments which could obtain revenue from other sources. Farm taxes were further eased by the expansion of state aid and the distribution of a share of various state-collected taxes to the local governments.

Business tax burden

Federal, state, and local taxes paid by incorporated business enterprises from 1922 through 1929 averaged, according to the federal Bureau of Internal Revenue, \$3,400,000,000 annually. Even in the depression year 1932, taxes paid by corporations amounted to \$2,400,000,000. The latest calculation that can be made shows that tax payments by corporations for 1937 totaled nearly \$5,000,000,000. If we add one-third to these figures to cover tax payments by un-

incorporated concerns—a very conservative estimate—business enterprises are shown as paying one-half or more of the country's taxes. During the prosperous 1920's taxes paid by corporations equaled one-third of their net income before deduction of taxes. Business taxes were collected during 1931, 1932, and 1933 although business was sustaining net losses. For the late 1930's, the proportion of taxes paid by corporations to their net income before taxes was between 40 and 45 per cent.

Can we assume, as do many opponents of business taxation, that these Bureau of Internal Revenue figures indicate the *burden* of business taxes, that owners' and stockholders' income is reduced accordingly? No. Business enterprises *pay* many taxes they do not *bear*. Business enterprises shift to the consumers of their commodities and services a considerable proportion of the taxes they pay. Because of these shifted business taxes, gross earnings and hence "net earnings before deduction of taxes" are higher than if the taxes had not been levied. The ratio of business taxes to business income is a meaningless statistical calculation, useful for purposes of propaganda but not for fiscal knowledge. In the absence of detailed studies on the shifting of specific taxes paid by business enterprise, we have no measures of business tax burden.

State manufacturers and trade associations, fighting to reduce the tax burden on their members, frequently assert that business is being "driven out" of their state by high taxes. Such dispassionate studies as have been made on this issue indicate that there is no inverse correlation between a state's tax burden on business and its business development.⁸ And analysis of the determinants of industrial location has established taxation as a factor of inconsiderable influence. Conceivably, if business tax burdens as between two states became widely divergent, some migration of marginally mobile firms from the higher-taxing to the lower-taxing state might occur. But the divergence would have to be far greater than the present differences between state business tax burdens to exercise any appreciable effect on business location.

⁸ See Merlin H. Hunter, "Effects of Taxation on the Localization of Industry," *Proceedings of the Thirteenth National Tax Association Conference*, 1937, pp. 179-186, see also George A. Steiner, *The Tax System and Industrial Development* (University of Illinois, Bureau of Business Research, Business Research Bulletin No. 57, Urbana, 1938).

CHAPTER XV

Property Taxes

TAXES on property, as previously indicated, are the major source of revenue for local governments, and are still an important source for some state governments. General property levies, and various special property taxes, produced approximately half of the tax revenues enjoyed by these governmental units during the past ten years. Our study of American taxes fittingly opens with an analysis of the property tax, the most important of our taxes.

HISTORY

Property taxation attained its fullest development in the United States—to the point where the so-called “general property tax” is sometimes considered a purely American form of taxation. As a matter of fact, the history of property taxation is a long one; examples of its levy are found in the ancient and medieval European civilizations.

In Roman times, property was occasionally taxed under the *tributum civium*. At first applied only to land and fixtures, this tax was subsequently broadened to include ships, carriages, furniture, clothing, and other forms of tangible personalty. Property taxes were the basic tax revenue source for the medieval English, German, French, and Flemish towns. During the twelfth century, such taxes were levied throughout most of Europe to aid the Crusaders. Later they found an established place in the fiscal systems of the states which crystallized out of the Medieval Era. In France and other countries, the general property tax was badly weakened by broad exemptions to the nobility and clergy. Everywhere, also, the growing bulk of personal property evaded the tax. In the

course of the nineteenth century, European general property taxes shrank definitely to real property taxes, in which form they still have a place in the tax systems of the present European countries.

Early American property taxes

Land taxes appeared intermittently in the tax systems of the American colonies. In New England, poll taxes and "faculty" levies on artisans' earnings were generally more important than land taxes. Customs duties and internal excises produced the bulk of the revenue in the southern and middle colonies.

During the 1790's and 1800's, the local governments and the newer states of the west had increasing resort to land taxes. Unlike modern property taxes, these early land taxes were not levied as a permillage on land values but as specific rates per acre on different types of land. For the older states they remained at most a supplementary source of revenue until after the War of 1812. From 1815 on, the state and local governments not only placed greater fiscal dependence upon the land tax, but expanded it into a "general property tax." One category after another of heretofore nontaxable personalty was brought upon the lists. Eventually, in state after state, general taxation of all properties replaced the growing lists of taxable specified properties. Furthermore, in contrast to the early specific personal property taxes which had provided varying rates for different classes of property, the new "general property tax" embodied the principles of uniformity of tax rate and universality of application. The Illinois constitution of 1818, the Maine constitution of 1819, and the Missouri constitution of 1830 required personal and real property to be taxed at a uniform proportion of value.

A change was taking place, too, in the nature of land assessment. Most of the older land taxes had been acreage taxes. Land was classified into two, or at the most three categories, and taxes of so many cents per acre were levied on each category. Now the laws were amended to base land taxation upon value. Instead of merely *listing* the land in his district, the local assessor was now called upon to *appraise* it.

Land and personalty appraisal raised problems of equalization

and review¹ that had not been present when listing was the only procedure involved. By 1828 Pennsylvania, Michigan, Ohio, Vermont, and Indiana had provided for county equalization. State equalization was instituted somewhat later in Maine, Vermont, Connecticut, and Ohio.

The general property tax in flower

By the Civil War period, the general property tax was the established basic local and state tax. The transition from separate levies on specified classes of property to a general levy on all property with specified exemptions, was practically complete. On the statute books, at least, property listing for taxation had been almost entirely supplanted by property appraisal or assessment. Tax rates were imposed as percentages or permillages of the property valuation, rather than as fixed charges per unit of property.

During the second half of the nineteenth century, centralization of certain aspects of property tax administration was the outstanding development in the field of property taxation. Early administrative organization had been exclusively local—assessors and collectors were village, city, town, and county officials. State levies were imposed on these local assessments, and were collected by local officials. But state levies necessitated equalization among local assessments, and even before the Civil War, a few experimental state boards of equalization had been established to undertake this function. During the two decades following the war they became universal. Popular hostility to the railroads and the general breakdown of property tax assessments under the high tax rates following the Civil War were reflected during the late 70's and 80's in widespread provision for assessment of railroad properties by the state boards of equalization. In some instances the boards were empowered to assess property of other public service corporations.

Additional impetus to centralized property taxation during the 1890's was the replacement of state boards of equalization by state tax commissions in ten states. Whereas the personnel of the older

¹ The techniques of equalization and review are explained later on pp. 393 and 391 of this volume.

equalization boards had been *ex officio* and only incidentally interested in tax matters, members of the new commissions were generally appointed and paid to devote themselves exclusively to tax work. These commissions took over the functions of property tax equalization and review. In addition, they were generally given considerable supervisory authority over all general property tax administration.

Twentieth-century developments

Property tax assessments, levies, and collections increased steadily from 1900 to 1930, dropped sharply during the depression, expanded again after 1934. The already marked tendencies toward administrative centralization became more pronounced, and property tax assessment and collection became more efficient.

But the general property tax was during these years subjected to a ground swell of criticism. It was charged with severe distributive shortcomings, with imposing an undue burden on one subject of taxation—land—while other subjects escaped with lighter tax liability. Effective taxation of personal property was declared an administrative impossibility. Influenced by this criticism, state legislatures whittled away at the weaker portions of the tax. In some states the property tax on intangibles was altogether abolished, to be replaced by personal income and special business taxes. Property levies on certain classes of tangible personalty were replaced by stock-in-trade taxes, motor vehicle license taxes, tonnage taxes, and other *in lieu* taxes. Other states, seeking to retain the universality of the general property tax by sacrificing its uniformity, subjected intangibles and occasionally tangibles to special low rates or to special low statutory ratios of assessment. Two recent attacks on the general property tax have been along the lines of rigid “over-all” or blanket rate limitations and of homestead exemption. These developments are discussed subsequently in this chapter.²

Generally, as previously indicated, the state governments in recent years have developed their revenue systems on other bases than property taxation. In a number of instances they have completely

² See p. 398 and p. 368 of this volume.

or practically relinquished the property tax to their local governments. Eleven states in 1938 imposed no state general property levies for ordinary revenue purposes, although some of these eleven imposed small general property tax rates earmarked to special purposes, and some had state rates on special types of property. Only in Nevada did the state government obtain more than 30 per cent of its revenue from property taxation; for four other states property taxes produced between 20 and 30 per cent of state tax revenues. Elsewhere the property tax is a minor source of state revenue.

BASIS

The legal subject of state and local property taxes is either "all property within the jurisdiction of the state or district except for such exemptions as are allowed by statute," or "such classes of property within the jurisdiction of the state or district as are specified by statute." "Value of the property as assessed for tax purposes" is the measure of these taxes. As we shall see, the types of property subject to property taxation and the definition of "value" employed for tax purposes, vary widely among the states.

Classes of taxable property

Allowing for exemptions noted subsequently, all categories of real property are generally subject to taxation. In some states, however, the operative real property of railroads and certain public service corporations³ and of mining enterprises⁴ is withdrawn from general property taxation and subjected to special *in lieu* taxes.

Most states still tax tangible personalty, but deep inroads are being made on this formerly universal levy. Pennsylvania and New York have abolished tangible personalty taxation altogether. In Delaware tangible personalty is taxable as a matter of law, but in practice livestock is the only item listed. And in Massachusetts and some other states, the personalty of corporations subject to the state franchise tax is withdrawn from property taxation. A third of the

³ See p 515 of this volume.

⁴ See p 523 of this volume.

states exempt motor vehicles from their general property taxes and regard the motor vehicle taxes as partial substitute. Three states impose special license taxes on merchants *in lieu* of a property tax on their shelf stocks. In two Atlantic Coast states and three Great Lakes states vessels are withdrawn from property taxation and subjected to tonnage taxes. Ohio, North Dakota, South Dakota, and Wisconsin exempt grain in elevators from property taxation, and impose *in lieu* bushel taxes. Severance taxes on cut trees *in lieu* of property tax levies on the growing trees are found in a number of states. In many states, the gross receipts taxes imposed on railroads and public utilities and the severance taxes imposed on mines and oil wells replace personal as well as real property taxes on these items.

Application of property tax rates to mortgages duplicates part of the tax on the gross value of mortgaged real or tangible property. Taxing corporate stocks and bonds as well as the real and tangible property owned by corporations involves repetition of tax burdens. Thus taxation of most forms of "representative" intangible personalty involves double taxation. In general, these taxes on intangibles, when imposed, are evaded to such an extent that they are practically taxes on honesty. They could be made effective by the application of sufficient administrative cost and effort, but in view of the distributive injustice involved, there is serious question whether the results would warrant the cost and effort. For these reasons, most fiscal authorities recommend that intangibles be withdrawn altogether from property taxation; the National Tax Association's model tax law embodied this provision. By law or practice, eighteen states already exclude all or practically all intangibles from property taxation. Most of the other states have withdrawn from property taxation specific classes of intangibles—bank deposits, mortgages secured by taxed domestic property, shares and bonds of corporations otherwise taxed by the state. In seven states some or all of these classes of intangibles are subjected to *in lieu* recording taxes; in another nine there are special income tax rates which can be viewed as substitutes; elsewhere no substitute tax is imposed.

Exemptions

As of 1936, nearly \$26,000,000,000, slightly over 15 per cent of the total property values of the country, were exempt from property taxation. For constitutional reasons, no state or local government may tax property of the federal government or of its instrumentalities unless specifically authorized by Congress.⁵ Such property is usually expressly or impliedly exempted from property taxation. Ordinarily the values involved are relatively unimportant and do not substantially restrict the property tax basis, but in some states the presence of extensive federal forests or Indian reservations seriously restricts the basis for state and local taxation. A survey several years ago indicated a \$9,000,000 state and local "tax loss" on Indian lands located in 243 counties of 23 states; the state and local governments concerned could draw no tax revenue from these reservations, although they had to spend some \$3,000,000 a year providing services for them. An attempt was made to avoid similar embarrassment over property values created by various "New Deal" projects, either by granting state and local governments permission to subject the property to nondiscriminatory tax rates or by providing for contractual payments as substitutes for taxes to the state and local governments involved. The whole subject is still in a state of confusion—so much so that in 1940 the President created a Federal Real Estate Board to work out some sound tax-substitute policy for these federal properties.

Were state or local governments to tax their own properties, they would in effect be shifting funds from one pocket to another. Hence their own properties are generally exempt from property taxes. But a true conflict of interests arises if a state park or forest reserve is established within the confines of some local taxing district, or if the waterworks or special institutions of one local unit are established within some other local unit. The loss of taxable values to the unit within which the properties are located may produce a serious revenue problem. In some states such public properties are

⁵ *McCulloch v. Maryland*, 4 Wheat. (1819) 316; *Weston v. Charleston*, 2 Pet. (1829) 449; *Van Brocklin v. Tennessee*, 117 U. S. (1886) 151; and bank tax cases cited on p. 386 of this volume.

subjected to the local tax rates of the unit within which they are located. But the practice is far from common.

General property tax statutes commonly exempt nonprofit-producing properties used for educational, religious, or charitable purposes. The institutions owning these properties are nonprofit enterprises performing social services that state or local governments might otherwise have to undertake. To limit the activities of these institutions by compelling them to use part of their resources for taxes would hardly further the purposes of government. In opposition to this exemption, it has been argued that such institutions tend to cluster in particular communities. In time, the communities may find themselves deprived of a large fraction of their tax base, thereby throwing an excessive tax burden on the non-exempt property. Several inquiries have shown, however, that this danger is more a matter of argument than of present fact.

Farmers are frequent beneficiaries of special property tax exemptions. Besides being allowed in a third of the states exemptions on their implements, they are in some states favored by crop exemptions. A growing crop is deemed in law a part of the land in which it is rooted. But in setting a value for the land, it is doubtful whether assessors take into consideration the value of a crop on the ground. Growing crops are specifically exempted from property tax assessment in nearly one-fourth of the states. After a crop is cut, it is taxable to the farmer as personalty, and as such is likely to be noted by the assessor. A considerable number of state legislatures exclude even cut crops from property tax assessments, on the theory that cut crops are the essence of a farmer's income rather than an element of his property on some particular date. Further to encourage their farmers, a few states exempt agricultural products grown in the state when these have been purchased and are held by manufacturers.

Fifteen states authorize their local governments to attract new manufacturing establishments by the lure of five- or ten-year property taxation exemptions.⁶ In a few cases the exemption applies to

⁶ See National Association of Assessing Officers, *Exemption and Preferential Taxation of Factories* (Bulletin No. 24, 1939).

all new manufacturing establishments. More often it relates only to specified industries which the state is anxious to encourage, such as wood-alcohol distilleries in Mississippi and beet-sugar factories in Wyoming. Sometimes the state law specifies the term and conditions of the exemption; sometimes it merely permits local governments to make such exemptions at their own option. The practice merits unqualified condemnation. Surveys have indicated that in determining the location of sound, substantial industrial enterprises, relative tax burdens are a minor consideration.⁷ Tax exemption is an important attraction only for fly-by-night concerns, which in the long run bring more loss than gain to the communities wherein they settle.

Somewhat allied with this exemption of new manufacturing properties is the more justifiable exemption of newly constructed dwelling houses to encourage home building. New York State authorized such exemption in 1920 to help overcome the housing crisis then existing in several of the large cities.

Special minimum exemptions for administrative or social reasons have long been a common feature of property taxation. Frequently these take the form of a flat personalty exemption for amounts under \$200 or \$500. Sometimes a minimum realty-personalty exemption is allowed to a particular class of taxpayers—to veterans, to widows and orphans, or to the widows and orphans of veterans. During the past few years the idea of a general minimum property tax exemption to all home owners—the “homestead” exemption—has gained remarkable headway. Texas initiated the movement in 1932 with a constitutional exemption of all “residence homesteads” under \$3000 in value.⁸ By 1938 eleven states allowed complete or partial “homestead” exemptions, ranging in value from \$500 in Wyoming to \$5000 in Florida and Mississippi, in South Dakota the exemption is on an acreage basis—160 acres of rural property or one acre of urban property. Two National Tax Association committees and most writers on tax matters condemn the “homestead” exemp-

⁷ See Kenneth J. McCarren, “Luring Industry through Tax Exemption,” in Tax Policy League, *Tax Exemptions* (the League, New York, 1939), pp. 34-42.

⁸ South Dakota in 1919, and Wisconsin in 1923, had exempted improvements on homesteads, but these laws were soon repealed.

tion on the ground that it limits sharply the tax base of many local governments and adds to their fiscal difficulties, and because it shifts an undue tax burden onto the nonexempt properties; a \$4000 homestead exemption reduces the assessable base by some 20 per cent, a \$2000 or \$3000 exemption reduces it around 15 per cent, and even a \$1000 exemption results in a 10 per cent reduction of assessments.⁹ Offsetting such criticism, however, are two supporting considerations—this exemption promotes somewhat the movement for home ownership, and it forces local governments away from exclusive dependence on property taxation.

Jurisdiction to tax

Under the federal Constitution, a property tax levied by the federal government must be apportioned among the states according to population. Practically, this eliminates property taxation as a source of federal revenue. On three occasions only, the last time during the Civil War, has the federal government imposed an apportioned general property tax.

Real property is taxable only by the state of its location. Tangible personalty, formerly attributed to the state or district of the owner's domicile under the fiction of *mobilia sequuntur personam*, is now held taxable only by the state wherein it is physically located or wherein it is construed to be located.¹⁰ There is considerable divergence among the states, however, as to taxable situs of tangible personalty within state boundaries. Most states provide for the assessment and taxation of tangibles in the district wherein they are located. Some twenty states still assign tangible personalty to the district of the owner's domicile, but more than half of these permit such property to acquire taxable situs in the district wherein it is permanently employed for business purposes. The interstate commerce limitation prevents the application of state and local property taxes to articles actually being transported in interstate com-

⁹ National Association of Assessing Officers, *Exemption and Preferential Taxation of Homesteads* (Bulletin No 20, 1939), p 11

¹⁰ *Union Refrigerator Transit Co. v. Kentucky*, 199 U. S. (1905) 194; *Johnson Oil Refining Co. v. Oklahoma*, 290 U. S. (1933) 158.

merce.¹¹ But these articles may be taxed before they enter actual transportation,¹² and after they come to rest at the end of their interstate journey.¹³ Property taxes may also be levied on property used in interstate commerce—such as vessels, tracks, wires, cars, and so forth—provided that no discrimination is exercised against such property.¹⁴

Intangible property is still generally taxed by the state and district of the owner's domicile, although some states have made allowance for its acquiring a special situs in the district where it is permanently employed in business. Neither federal nor state constitutions bar the double taxation involved when both real and tangible property and their representative intangibles are taxed. Thus mortgaged land may be taxed on its full value to the mortgagor while the mortgage is taxed to the mortgagee. A corporation may be taxed upon the full value of its land and tangible assets and upon the intangibles it owns, while the shareholders and bondholders may be taxed upon their shares and bonds. The law views the mortgage and the mortgaged property, the corporation and its securities, as distinct and independent properties. Such economic duplication of tax burdens as results from the taxation of both parties is not recognized as a discrimination forbidden by constitutional limitations. But, as previously indicated,¹⁵ many states bar such double taxation by withdrawing specified classes of intangibles from general property taxation.

“Taxable value”

In all states the measure of property taxes is the capital value of the taxable property as of assessment day. But the legislatures have indulged in many vagaries in attaching qualifying terms to “value.” Property tax laws specify “true cash value,” “fair cash value,” “fair market value,” “true value,” “fair value,” and “actual value.” The courts have contributed their quota of confusion. In Louisiana one

¹¹ *Bacon v Illinois*, 227 U S (1913) 504.

¹² *Diamond Match Co. v Ontonagon*, 188 U. S. (1903) 82

¹³ *Pittsburgh and S Coal Co v. Bates*, 156 U S (1895) 577.

¹⁴ *Old Dominion Steamship Co v. Virginia*, 198 U S. (1905) 299.

¹⁵ See p. 365 of this volume.

court held that "cost" was "value" In one Connecticut case a court accepted as the proper base the cost of replacement less depreciation, while in Alabama such a figure was held to have no bearing. A Wisconsin court said the thing to strive for was strict cash realization under prevailing conditions. A Washington court believed that the statute meant not "exchange value" but value to the owner using the property involved. A New Jersey decision, in admitting the probability of lack of an actual buyer for certain property, indicated that the assessors might properly estimate what a hypothetical buyer would give. Underlying this conflict of phraseology and opinion is a general formula, sanctified by age and constant if sometimes meaningless repetition—"Taxable value is the price which a property would bring in an open market on a free, not forced, sale between a willing buyer and a willing seller."

Recently under discussion has been the possibility of taxing land and buildings on "annual income" instead of capital value. "Annual income" value, runs the argument usually advanced, would omit the speculative elements frequently present in land values, and result in fairer taxation. But, as happens so often when the issue of "justice" intrudes itself into tax discussion, a flatly contradictory argument can be sustained—speculative value, it can be argued, involves an element of taxpaying "ability" and should be subject to levy. Furthermore, an "income value" tax, since it would impose no burden on undeveloped properties, would encourage the holding of land out of use for speculative purposes. And the secondary argument, that "income value" would be easier to ascertain and assess than "capital value," is open to serious question if not flat contradiction.

The theory that property values are assessed as of a particular date is awkward in its application to the stocks of merchants and manufacturers. Moderate ingenuity will enable a merchant or manufacturer to reduce his inventories to a minimum on the assessment date. Having obtained the advantage of a low valuation, he is then free to increase his inventories to the current requirements of his business. To prevent such "marshaling" of inventories to avoid taxation, a third of the states have provided that merchants

and manufacturers shall be assessed on the average of their stocks over the course of a year or some large fraction of a year.

ASSESSMENT OF ORDINARY PROPERTY

Assessment—the listing and appraisal of the properties subject to taxation—is the crucial element of property tax procedure. Here are found the glaring weaknesses and abuses which have opened property taxation to a barrage of criticism and condemnation.

Assessment organization

Assessment of personal and ordinary business properties is everywhere performed by local assessors. In sixteen states these assessors are city, village, town, and school district officials. In the other thirty-two states they are either exclusively county officials, or a combination of county and subdistrict officials. In some of the states where the duties of the county and subdistrict assessors overlap, independent assessments of the same properties at different values may be made by various groups of assessors.

Critical opinion is unanimously hostile to the village, town, and school district assessment which still survives. Both the National Association of Assessing Officers¹⁶ and the National Tax Association¹⁷ advocate an assessment district large enough in area and taxable resources to permit the employment of one full-time assessor and at least one assistant. A village, a town, a school district assessment area cannot afford a full-time salaried assessor. Too often, rural assessment is performed on a part-time basis at a compensation which compares unfavorably with a laborer's wage, and the function suffers accordingly. Even where a small, poor county cannot support an adequate assessor's office, it can at least do better in this direction than any of its subdistricts. County assessment has the further advantage of removing the assessor's office to some extent from the influence—not necessarily willful and pernicious, but

¹⁶ National Association of Assessing Officers, *Assessment Organization and Personnel* (the Association, Chicago, 1941), p. 51.

¹⁷ National Tax Association model tax plan, *Proceedings of the Twenty-Sixth National Conference*, 1933, p. 406.

none the less dangerous—of his immediate neighbors and electors.

About 97 per cent of all town, township, and village assessors, 87 per cent of all county assessors, and 33 per cent of all city assessors are elected. Their terms of office vary from one to six years, with high frequency of re-election; their pay is usually on a per diem basis, ranging from \$2 to \$10.

Critical opinion unanimously favors appointed assessors. The elected assessor is too often a vote getter instead of a competent appraiser and administrator, or worse yet, he is a creature of the local political "machine" and misuses his office to further the "machine's" ends. The almost incredible assessment abuses perpetrated by an elected board of assessors in Chicago during the 1920's¹⁸ were remarkable more for their magnitude than their inherent character; on a smaller scale, a similar tale could be told of many an elected county or district assessor's practices. And when election puts an honest and able man into an assessor's office—as, fortunately, it frequently does—he labors under a heavy handicap. If he hopes for re-election, he must continue to be politician as well as tax administrator—he must retain the backing of his party organization, he must curry favor with the voters. Divided interests of this sort necessarily reduce an assessor's efficiency.

An appointed assessor having at least a four-year term of office is the solution generally recommended. It must be recognized, however, that serious dangers also lurk in a system of appointment. If the office of tax assessor is at the complete disposal of a board of county supervisors or an equivalent body, it will often be made a political gift, a reward for party regularity and political effort rather than fitness for the office. This hazard can be met by requiring appointment to be made from a list of candidates certified as to fitness by a competent and impartial agency—say, by the tax commission of the state. As a further safeguard, the state tax commission might be empowered to remove appointed assessors upon proof of incompetence or malfeasance in office. While the actual

¹⁸ Herbert D. Simpson, *Tax Racket and Tax Reform in Chicago* (Institute of Economic Research, Chicago, 1930)

exercise of such removal power might be rare, its existence would be a powerful urge toward maintaining state-wide standards of assessment practice.

State agencies for the "supervision" of local assessment procedure are found in all states but Delaware and Pennsylvania.¹⁹ In most cases this "supervision" is a mere "paper" power, never exercised by the state tax commission or board of equalization. In some twelve states the commissions perform the valuable service of preparing and prescribing assessment forms and compiling "manuals" of regulations and suggestions for the local assessors; and they frequently sponsor assessors' conferences. The Maryland, Massachusetts, and Wisconsin tax departments go a long step further and provide corps of "supervisors" to train, advise, assist, and cooperate with the county or local assessors. From all reports, the services of these "supervisors" are invaluable in maintaining the high quality of assessments in these states.

Despite the strong sentiment for local fiscal autonomy, the actual assessment of certain classes of property has been transferred from local assessors to state officials. First to be subjected to central assessment was the operative property of railroads. Subsequently, central assessment was in many states extended to the property of other public service enterprises,²⁰ and more recently, to the property of motorbus and motor truck lines.

Central assessment procedure has until now been limited to the property of public service corporations. Many industrial corporations, however, have properties which in their complexity and difficulty of assessment rival those of public service corporations. Their assessment is often beyond the capacities of the average assessor. Furthermore, when the various units of an industrial enterprise are scattered over a considerable area, no one local assessor is able to value the enterprise as a whole. Some of the industrial states may soon find it desirable to bring the property of certain classes of industrial enterprises under central assessment.

¹⁹ National Association of Assessing Officers, *op cit*, Ch. X.

²⁰ For further details on the subject of central assessment of public service enterprise properties, see p 388 of this volume

Rural realty

Annual assessment of all real estate is provided in the property tax laws of twenty-six states. From two to ten years may elapse between realty assessments in the other states. In preparation for each assessment date, the assessors are supposed to receive lists of taxable property from their owners, to "view and value" the taxable real estate and specified items of tangible personalty, and to enter the appraised values on a "tax roll."

Real estate "appraisals" by rural assessors are frequently farcical.²¹ In countless cases, rural assessors content themselves with copying the tax rolls of their predecessors. Amazing values of property are omitted from the lists year after year. A marked general rise or general fall of land values in the area is covered by a proportional raising or lowering of all values listed on the tax roll. Time and again, assessed values set against listed properties bear no recognizable relation to their true values. Acting on their own initiative or, as in Louisiana, on instructions of the state tax commission, many assessors classify land into various arbitrary categories, either establishing uniform unit values for each category or setting maximum and minimum unit values. By this procedure, property taxes applied to land are obviously transformed into the classified land taxes of eighteenth-century type.

Happily, a growing number of assessors' offices are making a serious technical approach to their function. They check their property lists against tax maps based, in many cases, on aerial photographic surveys. They assess land and improvements separately. Shrewd rule-of-thumb methods based on experience and local knowledge enable them to make fair appraisals of farm and village buildings. When and as available, they use sales data to check their listed valuations. And they apply various technical aids—filing systems and standardized entry cards for recording information about each parcel of property²²—to further and main-

²¹ See Joseph D. Silverherz, *The Assessment of Real Property in the United States* (New York State Tax Commission, Special Report No. 10, 1936).

²² A sample form card for entering data for rural real property assessment is reproduced in Appendix B, p. 798 of this volume.

tain the accuracy of their appraisals. In Michigan, during 1936 and 1937, the state tax commission in cooperation with the federal Resettlement and Works Progress Administrations undertook a \$2,000,000 "rural property inventory project," which provided that state with a superb set of rural property valuations.

The best rural assessment is still far from perfect. In spite of all tax maps and records, occasional parcels of land escape listing—but they are not many. Inequalities of assessment as between individuals occur—but they can be corrected by efficient review.²³ These incidental faults do not prevent a good assessment roll, so far as it relates to rural lands and buildings, from being the basis of a sound, fair tax levy.

Urban realty ²⁴

Land and building assessment in many of the larger cities has assumed the character of a scientific technique. City tax offices begin their land assessment procedure with a "block and lot map"—a detailed topographic plan of the city showing every block and lot, each with its own key number. Initial preparation of such tax maps is expensive, but in use they earn their cost many times over.

The first step in the preparation of a "block and lot" map is to establish the value of a standard-depth lot in the center of each block. There will, of course, be wide variations between these standard-lot values from block to block, according to business and residential zones of the city, according to convenience to traffic facilities, and as between main streets and side streets. Often the current market value of a lot and building somewhere along a block can be discovered from sales records. Sometimes it is possible to calculate the value of various lots and buildings in a block by capitalization of their net rentals. With one or more building-and-lot values either determined or calculated, lot values are ascertained by the "residual" method of ascertaining building values and sub-

²³ See p 391 of this volume

²⁴ The most comprehensive analysis of urban assessment techniques is National Association of Assessing Officers, *Urban Land Appraisal* (the Association, Chicago, 1940).

tracting them from building-and-lot values. From lot values so calculated, the value of a standard-size center lot in each block can be estimated, by making allowance for value differences that exist between the center and end of each block. As a final step, this center-lot value is reduced to a "frontage foot" value, by dividing the lot value by the number of feet of its width. All of these calculations have been standardized for city assessors, and the assessors' manuals contain tables that simplify the arithmetical problems involved.

A "center foot value" calculated for each block by the above technique is entered upon the "block and lot" map.²⁵ For lots on either side of the central one, successively higher values per "frontage foot" are assigned by pre-established scale; maximum values are assigned to corner lot frontages. To determine the value of a standard-depth lot, its particular "frontage foot value" is multiplied by its frontage. Non-standard-depth lots and irregular-shaped lots are valued by the use of tables constructed on the principle that the unit depth value of a city lot diminishes as the distance from the frontage increases. Assessed values are entered upon separate file cards for each lot.²⁶

City buildings are generally assessed separately from the lots on which they stand. As a rule, city assessors' offices develop standard assessment record cards for various classes of structures—for single- and two-family residences, for apartment houses, for office buildings, for store buildings, for factories, and for miscellaneous buildings.²⁷ Record notations include cubic space or floor area, type of construction, utility, age, obsolescence, state of repair, various classes of fixtures, and the facility with which the building could be remodeled to serve other uses. To some extent, tables and formulas can be used in evaluating these various factors, but the assessors' experienced judgment must obviously be allowed considerable leeway. Once obtained, this information can be kept up to date by ordered

²⁵ A sample section of a "block and lot" tax map with "center foot values" entered upon it is reproduced in Appendix B, p. 799 of this volume.

²⁶ A sample urban site assessment card is reproduced in Appendix B, p. 800 of this volume.

²⁷ Sample urban building assessment record cards are reproduced in Appendix B, p. 802 of this volume.

reference to contractors' permit reports, and records on sales, mortgages, foreclosures, leases, and court appraisals.

In many small cities, and in a few large ones where the assessor's office is politics-ridden, land and buildings assessments suffer from all the abuses characteristic of the worst rural assessments. About ten years ago, a survey in a New England manufacturing town with 16,000 population uncovered 1896 buildings, lots, and improved parcels of land not entered on the tax map. Even more amazing, 49 of these omissions were on the town's main street—a mile or so long.²⁸ In a wealthy suburban community near New York City, the recent insertion of nonlisted properties raised the tax roll from \$121,000,000 to \$193,000,000. And, of course, the vagaries of unequal assessments in such communities are likely to be even greater than those of nonlisting. Chicago assessments in 1923 averaged 35 per cent of full value with individual valuations ranging from one per cent to over 100 per cent, and a 40 per cent average deviation from uniformity.²⁹ Such variations from the average assessment ratio make the "equality" and "proportionality" of property taxation a mockery.

Personalty

Personal property is assessed on the basis of sworn lists submitted by the taxpayers.³⁰ And the average taxpayer reports only those items which he knows are already known to the assessor or are

²⁸ Kent Sagendorph, "Tax Cameras Have Eagle Eyes," *World's Work*, September 1931, p. 62.

²⁹ Simpson, *op cit*, p. 37.

³⁰ The following effusion of the fiscal muse was submitted as a tax list for the Connecticut property and poll tax a century or so ago:

I have two poles tho' one is poor,
I have three cows and want five more,
I have no horse, But fifteen sheep,
No more than these this year I keep,
Steers, that's two years old, one pair,
Two calves I have, all over hair,
Three heffers two years old, I own
One heffer calf that's poorly grone,
My Land is acres Eighty two
Which sarch the Record youle find true,
And this is all I have in store,
I'll thank you if youle Tax no more.

easily discoverable by him. Naturally, the taxpayer places upon them the lowest conceivable valuation. Upon information, inspiration, or guess, the assessor adds such values as he sees fit, knowing full well that his final figure is quite arbitrary and probably without relation to the actual value of the taxpayer's personal wealth. Should the assessment chance to exceed the property's value, the taxpayer "swears off" the excess.

Some types of tangible personalty cannot well escape the assessor's list; other types are notorious evaders. Farm flocks and herds and farm machinery—matters of public knowledge in rural regions and open to the eye of the assessor—are generally listed in full. Merchants' and manufacturers' stocks of goods usually appear on assessment lists by compromise agreement between the assessor and the taxpayer, rather than on the basis of accurate appraisal. Machinery, and store and office equipment are listed at purely nominal values, if at all. Household furniture and personal belongings are listed for the most part only when they are owned by rich individuals. In this case also, their evaluation is a compromise agreement between the taxpayers disinclined to list their property and assessors who have no intention of attempting an inventory of the taxpayers' possessions. City assessors sometimes approach the problem of assessing tangible personalty by fixing a presumptive value for each taxpayer's tangibles arbitrarily based upon such extrinsic indicia as the neighborhood of his residence, the character of his dwelling, and incidental information about his manner of living. Subsequently, the taxpayer is given an opportunity to prove that his tangible possessions are not worth the presumptive value set by the assessor.

Where intangibles are taxable, they are rarely listed. If a taxpayer refuses to state what stocks, bonds, or mortgages he owns, there is no way by which to extort a confession of ownership from him. Intangible property in trust and intangible property before the probate courts is sometimes listed, because trustees, executors, and administrators are required by virtue of their office to list it. Otherwise, taxpayers generally refuse to obey the law. Real property and tangible personalty may, after they are listed, be assessed

at only a fraction of true value, but intangibles often bear their value on their face. Once they appear on the assessors' lists, they must be assessed at full value, and at present property tax rates, taxation of some categories of intangibles would absorb most of the income produced by such property. Recognition both of this circumstance and of the injustices which result from taxing basic real or tangible property as well as its representative intangible property, induces tax assessors to connive at the taxpayers' failure to list all or even any part of their intangibles. Many states report that for years the assessment of intangibles, total and per capita, has been declining in spite of steady economic growth.

Suggestions for improving the listing of intangibles have been made at various times and by various writers. It has been proposed that a record be kept of bequests received by beneficiaries, to indicate a probable minimum value of their future personal estates. Reports of dividend and interest receipts from published income tax returns might be used as a guide to stock and bond holdings. Corporations doing business in the taxing state might be required, as are banks, to pay the tax on the shares owned by shareholders living within the state. Banks might be compelled to disclose collateral security for loans, and brokers might be forced to file lists of transactions. But popular support has never been ranged behind any of these proposals, because of the widespread feeling that the intangibles tax is fundamentally unfair, and the more effective its enforcement, the more unfair its operation. The one partial solution of the problem to receive any approval is the classified property tax with special low mill rates on intangibles.³¹

Underassessment and unequal assessment

Underassessment is much more a problem in the taxing of real property than of personal property. Once personal property is listed, a reasonable if arbitrary value can usually be assigned to it without great difficulty. In the valuation of real property, the assessor must exercise his judgment, and it often shoots wide of the mark. And when the assessor errs, it is likely to be on the side of

³¹ Discussed on pp. 404 ff. of this volume

underassessment, since the taxpayer would fight a valuation resulting in overassessment.

Several extraneous factors emphasize the assessors' natural tendency to undervalue rather than overvalue property under their consideration. When a county tax rate is levied on the valuations of local assessors, every assessor is inclined to undervalue the property of his district in order to reduce the amount of county tax it must pay. Low local valuations, of course, necessitate a higher local tax rate, but the total amount of local tax is not thereby increased. Similarly, the levy of a state tax rate encourages competitive underassessment by both counties and local districts. State aid distributed to local governments in inverse proportion to their original assessed valuations to equalize their respective resources³² may also encourage competitive underassessment.

Certain extraneous factors, it should be noted, tend to counteract the tendency toward underassessment. If part of a state-collected tax is distributed to local governments in direct proportion to their assessed valuations, local units find high assessments to their interest, since they thus obtain a larger share of the state-distributed funds. Also, where a constitutional provision or statute limits local tax rates and local debt by assessed valuations, a local government which is pressing close upon its tax rate and debt limitations may be forced to raise the level of its assessments in order to obtain more taxes or to float additional loans.

During recent years, the underassessment of realty and tangible personalty for property tax purposes has tended to diminish. According to figures published by the United States Bureau of the Census,³³ the average of the assessed values of real and tangible property throughout the country was 49.7 per cent in 1903, 54.0 per cent in 1912, and 63.2 per cent in 1922. On the eve of the depression, the ratio was close to 70 per cent, and it is probably much higher now. Back of this rise in the level of assessed valuations are improved assessment technique, the growing influence of state tax commissions over local assessments, increased distribu-

³² See p. 739 of this volume

³³ *Decennial Wealth, Debt, and Taxation series.*

tion of state-collected taxes to local governments, and the growing pressure of many local governments on their tax rate and debt limitations.

Average assessment ratios vary considerably among the states. In 1931 Iowa reported that her real property was actually assessed at between 13 and 18 per cent of true value. Massachusetts reported a 90 per cent assessment. Assessment ratios of individual properties in particular districts in each state also show wide variation. A survey of New York assessments for 1935 disclosed at the one extreme a village with an average ratio of 10 per cent and several towns with ratios between 10 and 20 per cent, while at the other extreme a number of towns reported ratios of 100 per cent or over. Within any district, individual properties may be assessed at anywhere from a minute fraction of their true value to considerably more than their true value.

Underassessment as such does not involve any injustice to individual properties or to classes of property. Were all properties in a state assessed at exactly one-half or one-quarter their true value, state tax rates would have to be double or quadruple the rates that could be levied if all property were assessed at full value. But underassessment would not change the tax paid by each individual property and by each class of property. Improper discriminations in the levy of the general property tax result from *unequal* underassessment.

Every property tax survey has shown that small urban properties are consistently assessed at a higher proportion of true value than large properties, with consequent class or social discrimination in property tax burdens. In rural assessment, the ratio of assessment for farm properties decreases as value per acre increases. City property assessments are generally higher than rural, both because city tax officials use more efficient assessment methods, and because many cities deliberately force up the assessment ratio to avoid pressure on constitutional or statutory debt or tax rate limitations. Finally it is to be noted that the further the general average of assessments falls from the standard of true market values, the wider

do the assessment ratios of individual properties vary, and the harsher are the discriminations involved.

Until recently, the courts offered no protection against inequalities of assessment ratio. If a taxpayer's property was assessed at more than true value, the courts would grant a reduction to true value. But they would not direct assessment to be lowered to the general level of the assessment of other property. The taxpayer's only remedy, they held, was to obtain an increase in the assessments of lower-assessed properties—a remedy legally unimpeachable but practically worthless. Recognizing the impracticality of this attitude, the federal courts now hold that the equal protection of the laws guaranteed by the Fourteenth Amendment necessitates lowering the assessment of property overvalued in comparison with other properties of similar character.⁸⁴ Taxpayers whose properties are relatively overassessed now have the remedy of a court proceeding. Actually, however, this remedy is for the most part available only to large public service and industrial corporations whose stake in tax discrimination is sufficiently high to warrant the trouble and expense of legal action; for the owner of an ordinary farm or residential property, litigation costs would exceed tax savings.

Six states have sought to prevent the injustice of unequal underassessment by providing that all properties be assessed at a specified fraction of their true value, in the hope that all properties would be equally underassessed at the statutory ratio. But this hope has not been fulfilled. In practice, the assessments fall below the statutory ratio and the variations in underassessment are as wide as in the states where full value assessment is required.

The strongest possibility of reducing unequal underassessment lies in the development of scientific assessment technique. In the absence of centralized state assessment with a uniform technique of valuation, partial improvement may be accomplished by preparing tax manuals for the use of local and county assessors, and by other indirect aid and assistance given by the tax commissions to the assessors.

⁸⁴ *Sioux City Bridge Co. v. Dakota County*, 260 U S (1923) 441.

ASSESSMENT OF SPECIAL CLASSES OF PROPERTY

Various types of business property are so complicated in character that their accurate appraisal is beyond the capacity of the ordinary county, local, or municipal assessors. Sometimes this difficulty is solved by withdrawing them from general property taxation, and subjecting the enterprises owning them to other taxes—*in lieu* taxes, perhaps, imposed specifically as substitutes for the property tax, or general “business” taxes that have no legal or economic tie-up with property taxation. Quite as often as not, however, the property tax is retained for these exceptional classes of property, but special assessment procedures are developed for them.

“Corporate excess”

A profitable business enterprise, whether operated as a corporation or under personal or partnership management, invariably is worth more than the appraisal value of its property assets. In the case of personal or partnership enterprises, this intangible asset fails to appear on the property tax roll, mainly because it is not susceptible of dollars-and-cents assessment, except under unusual circumstances. Every element of incorporated business, however, has its pecuniary equivalent. Even though the intangible element of corporate “going-value excess” may not be included in book values, transactions in the stock of the corporation give it market value in many cases. Corporate “going-value excess” being a determinable factor, nine states isolate it under the name “corporate excess” and tax it as intangible personalty under the general property taxes.³⁵

Generally, the market value of the capital stock is taken to be the capital value of the taxed corporations. Four states use a combined stock-and-bond calculation. But whether property taxed under the general property is to be deducted at assessed value or book value is not always clearly indicated in the tax laws. Given

³⁵ On the statute books the tax is sometimes called “franchise tax,” “corporation personalty tax,” or “moneyed capital tax.” Only in Massachusetts and Rhode Island, where the corporate excess tax has been withdrawn from the general property tax and made a special state levy, is it successfully imposed. A sample corporate excess return is reproduced in Appendix B, p. 804 of this volume.

the alternative, it may be assumed that the taxed corporations report their property at book value. Property taxed in other states is usually deducted in the calculation of corporate excess.

Five states provide for the assessment of corporate excess by the state tax commission. Usually the general property tax rate current in the district of the taxed corporation's principal office is applied. Three states apply special state rates.

Bank shares

Quite unintentionally, the National Banking Acts of 1864 and 1868 determined the system of state and local bank taxation that was to prevail in the sixty years following. As federal instrumentalities, national banks might not be taxed by state or local governments without federal permission. The National Banking Act authorized the application of the general property tax to the real property of banks. National bank shares might be taxed to their holders as intangible personal property, but at a rate no higher than that imposed on "other moneyed capital" or on the shares of state banks. While the National Banking Act could not direct the taxation of state banks, the states were indirectly impelled to tax state banks identically with national banks. If they levied lighter taxes on state banks, their national bank taxes would be invalid under the National Banking Act. If the state bank taxes were the heavier, many state banks could escape them by taking out national charters and becoming national banks.

For sixty years the system of state and local bank taxation was uniform throughout the United States. Bank-owned lands and buildings were taxed under the prevailing general property tax. Bank shares were taxed as personal property to the holders. Unlike other intangibles, however, the tax on bank shares was assessed to and collected from the banks which issued them instead of the individual owners. Tax evasion by nonlisting was impossible, and in many states bank shares were the one form of intangible personalty actually assessed and taxed. Many states further provided that the assessment of bank shares was to be made by state officials and not by local assessors.

Generally, no distinction was made between commercial banks and savings banks and trust companies in the taxation of their shares. Savings banks in New England, however, came to be taxed on the basis of their deposits less the value of their investments in real estate and certain classes of securities. Because of these deposits taxes, the tax burden on savings banks was lighter than on other financial institutions.

In 1921 in *Merchants' National Bank v. Richmond*,³⁶ the United States Supreme Court decided that the words "other moneyed capital" in Section 5219 of the federal *Revised Statutes*, embodying the tax provisions of the National Banking Act, included all private investments. Many states had adopted classified property taxes with low rates on intangibles,³⁷ with bank shares not generally included in the low-rate categories. By placing them in the position of discriminating against national bank stock as compared with "other moneyed capital," this decision wrecked their systems of bank taxation. Taxing intangibles other than bank stock at special low rates now constituted a forbidden discrimination against national bank stock. Nor could the rate on national bank stock be lowered and the old rate on state bank stock be retained, since this would induce the state banks to reorganize as national banks. If the rate on state bank stock was also lowered, state and local governments would lose an important source of revenue. Worse yet, the Supreme Court decided a few years later that even when bank shares and other intangibles were taxed under uniform general property tax rates, if the bank shares were assessed at a higher proportion of full value than other intangibles, this too was invalid discrimination against national banks,³⁸ thereby threatening the extinction of the bank share tax.

We will not concern ourselves here with the subsequent amendments of the national banking law authorizing states to impose other types of taxes on national banks, or with such other bank taxes as have been imposed.³⁹ Our point here is that thirty-three

³⁶ 256 U. S. (1921) 635.

³⁷ See p. 000 of this volume

³⁸ *Montana National Bank v. Yellowstone County*, 276 U. S. (1928) 499.

³⁹ See pp. 519 ff. of this volume

states still retain the bank share tax, in many instances with rates or assessment procedures presumably outlawed by the Supreme Court.

In these thirty-three states, bank shares continue to be taxed presumably as intangible personal property owned by individuals. Except in Florida, New Hampshire, and Rhode Island, however, bank shares are assessed to the issuing banks instead of to the owners. Consequently, although other intangibles may escape listing for the general property tax, bank shares are listed and generally assessed at their full par value or at the full value of the capital, surplus, and undivided profit of the bank. Usually, but not always, the value of real estate owned by the bank and taxed under the general property tax is deducted from the assessed value of the shares, and to this extent the bank share tax partakes of the nature of a corporate excess tax. Three states also permit part or all of a bank's surplus to be deducted. Behind this deduction is the theory that taxes on surpluses and undivided profits discourage the desirable accumulation of bank surpluses.

Assessment of bank shares is generally made by the county or local assessor. In nine states, the state tax commission or other state tax agency either assists the assessors in their valuation of bank shares, or itself makes the assessment. And in Delaware the State Bank Commissioner performs this function.

Mineral and timber lands

Mining properties and growing timber stands present a peculiar appraisal problem—potential future profits must be translated into current valuations. The issues involved are too complicated and the values affected too considerable for the matter to be left to the rule-of-thumb procedure of the ordinary rural assessor. Tax commissions of the states with extensive mining and forest properties generally provide their assessors with formulas for valuing these properties. One approach to the appraisal of ore reserves is the Hoskild-Hoover formula, used in Arizona and several other mining states.⁴⁰ First, the salable metal content of the reserve is estimated

⁴⁰ National Tax Association, *Proceedings of the Twenty-Sixth National Conference*, 1933, p. 56

in toto. Probable costs of recovery and sale are deducted from this figure and the resulting estimate of net proceeds is then discounted to present worth on the basis of the current rate of mining operations. Timber lands in Maine and elsewhere are valued by a formula which starts with an estimate of the value of the timber that will eventually be cut. From this figure is deducted an allowance for carrying charges from present date to the time of cutting. To this "present" timber value is added the stripped land value—the value of land and growth below marketable sizes.⁴¹

Railroad and public utility properties

Most states charge the state tax commission, board of equalization, or other state tax administrative body, with assessing the operating property⁴² of railroads and public service corporations. Rarely is the attempt made to value such property as a collection of individual items. The physical valuation of an enterprise's properties is a laborious and expensive procedure.⁴³ Appraisers must choose between the unsatisfactory alternatives of original cost or replacement cost, although in periods of rising or falling prices neither basis fairly represents present value. To keep them available for tax purposes, appraisals must be repeated constantly, or some method must be discovered of revising them to date. Michigan and Wisconsin are frequently pointed to as states which made successful appraisals of railroad properties, but these appraisals were valuable as a basis for tax calculations for a limited time only; Wisconsin now depends primarily on a stock-and-bond valuation.

Assessing bodies more frequently seek to assess each enterprise as a "going" concern. When the "going" value of an enterprise is determined by a capitalization of net income, the assessing body

⁴¹ National Tax Association, *Proceedings of the Twenty-Seventh National Conference*, 1934, p. 250

⁴² "Operating property" is that property actually used in the performance of a public service enterprise's service. In the case of a railroad, it includes tracks and roadbed, engines and cars, terminals and stations, and possibly repair shops. In the case of an electric power company, it includes powerhouses, relay stations and transformers, wires, and poles.

⁴³ See Harley L. Lutz, *The Taxation of Railroads in New Jersey* (Princeton University Press, Princeton, 1940), Ch. III.

is put to the laborious task of determining net income, only to have the income figure capitalized by an arbitrary rule-of-thumb ratio. Furthermore, a valuation determined by capitalizing net earnings is likely to fluctuate widely as the net earnings of the enterprises vary from year to year. When the market value of a public service corporation's securities is used to ascertain "going" value, the assessment is made subject to speculative machinations on the stock exchange. Furthermore, if all or a large proportion of the shares of a public service corporation are owned by a holding company, there may be no active trading to set a market value. In practice, the assessing commissions and boards rarely confine themselves to only one of these two valuation methods. Instead, they seek by various arbitrary combinations to achieve some reasonable figure. Ultimately, *ad valorem* taxation of public service enterprises generally resolves itself into a bargaining between the assessing body and the legal representatives of the taxed enterprises, with the latter defending themselves by the threat of litigation against what they consider unreasonable valuations.

After the assessing body has determined a value for the entire enterprise, which operates in perhaps half a dozen states, a fraction of this value must then be allocated to the taxing state. A number of standards of allocation or "unit rules" have been developed. The most common "unit rule" is mileage—of railroad track, or telephone or telegraph wires, or piping, according to the class of enterprise involved. The fraction of the corporation's total assessed valuation allocated to the taxing state is determined by the ratio of its mileage in the taxing state to its total mileage. Gross collections, "traffic units," and location of tangible property are occasionally used as sole standards of allocation or "unit rules," frequently in combination with the mileage factor. For express companies and car companies, "route mileage" is the common standard of allocation. The nonoperating property of public service corporations is usually valued by the local assessors.

Public service corporation property is in most cases taxed by each local district at the prevailing rate, although a few states apply

special rates. Where such property is centrally assessed, the assessment must be equalized ⁴⁴ with other property assessments in the state, and the general state valuation must be distributed among the local governments. Mileage is the most common standard for local distribution. Obviously, however, it favors thinly settled districts through which railroad tracks or electric wires run as against the heavily populated areas which provide the traffic or consume the current. A few states use the location of the corporation's tangible property as the standard. In states where the nonoperating property of public service corporations is locally assessed, the distributed value of the operating property is added to the assessed value of the nonoperating property, and a common tax rate is applied to both.

⁴⁴ The subject of equalization is discussed on pp 392 ff. of this volume

CHAPTER XVI

Property Taxes (*Concluded*)

REVIEW¹

"DUE process of law" clauses of the federal and state constitutions require that every taxpayer receive notice of his assessment and be given an opportunity for a hearing upon it some time before the tax collection date.² Accepted as constructive notice is the posting of the preliminary assessment list or tax roll on some public bulletin board by the assessor or town or county clerk. During such period as is prescribed by state law or established by the assessor's regulations, a taxpayer may protest his assessment and have it "reviewed."

Organization

No uniformity in organization for property tax review exists as among the states or even within individual states. Where assessment is local, review proceedings may be conducted by an ex officio board of village, town, or school district officials, with privilege of appeal to the county board of review. In large cities, the assessing officials may sit as a board of review, or a separate bureau of review may be set up in the city's department of finance, or an independent board of review may be elected. County review is usually an ex officio function of the county board of supervisors, with or without the assessors sitting in on the review hearings, but other arrangements are common. When large values are involved, appeal from the findings of county boards of review can usually be had to the state tax commission or the state board of equalization. These

¹ The best recent studies of the review and equalization functions are in National Association of Assessing Officers, *Assessment Organization and Personnel* (the Association, Chicago, 1941), Chs. VII, VIII and IX.

² See *Turner v. Wade*, 254 U S (1920) 64.

county assessors remained unaltered, a uniform state tax would impose a heavier burden on property in counties with high assessment ratios than in counties with low assessment ratios. Unless inequality of assessment ratios among tax districts is neutralized by an effective equalization procedure, the more conscientious assessors who bring their valuations closest to "true" value merely penalize the taxpayers of their districts.

The procedure of modifying assessments to take account of differences in assessment ratios is called "equalization." Original assessments made by villages, towns, and school districts should be equalized before a county tax levy is imposed. The original assessments of the high-ratio districts must be lowered and those of the low-ratio districts must be raised to produce a presumptive equality of assessment ratios. Similarly, in states wherein a state property rate is imposed there should be state equalization as among the counties. A further refinement, found in twenty-five states, is state equalization as among classes of assessed property.

Organization

County "boards of equalization," found in fourteen states, are usually, though not always, identical in their personnel with the county boards of review. State equalization, now undertaken in thirty-eight states, was originally performed by a distinctive agency—the "state board of equalization." With the general evolution of state boards of equalization into state tax commissions, the equalization function became a duty of the latter. In a few states, the old boards continue to equalize property tax assessments while other tax functions are handled by tax commissions.

Procedure

Effective equalization can be developed for realty assessments. A state tax commission can consistently and carefully collect data on the sale prices of land and buildings throughout the state. And a comparison between these values and those listed by the assessors will give a sample basis for estimating the ratio of underassessment for each county or each district. Sales data computations are useful

both for county equalization among independently assessing districts, and for state equalization among counties. Both in Wisconsin and New York the collection and publication of such data by the tax commissions provides a sound basis for equalization.

Too often, however, equalization is either flatly neglected for lack of factual data on assessment ratios in the various districts or counties, or is performed in casual, superficial manner. A recent survey concludes that there is "less success than might reasonably be expected in state equalization."³ Customary equalization ratios established decades ago are continued year after year, although the assessment inequalities they are supposed to correct may have shifted widely in the interim. Or perhaps after the equalization board has submitted itself to an "ordeal by oratory" by representatives of the counties affected, a few witnesses are heard, a handful of sales values noted, the assessed valuation of one district is raised 10 per cent, that of another lowered by some equally arbitrary proportion. A county or state levy based upon such equalization cannot possibly result in a uniform or proportional burden.

And equalization can do nothing to correct nonlisting of personal property. No possible data are available to indicate the varying proportions of *nonlisting* as among districts or counties. The general practice is to apply to personalty the equalization ratio for real property, but this only compounds stupidity by futility.

RATE STRUCTURE

In eighteen states, as will be discussed,⁴ special state-wide mill rates are applied to certain classes of intangible personalty, and in a few instances to elements of tangible personalty. Otherwise each school district, each village, each city, each town, each county, and with some exceptions each state determines its own property tax rate. Since every property is located within the territory of two or more superimposed taxing governments—a school district and a county at the very least—the taxpayer's bill embodies two or more superimposed independent rates. For example, 1933 tax bills for the Hyde

³ National Association of Assessing Officers, *op. cit.*, p. 2.

⁴ See pp. 405-406 of this volume.

Park district of Chicago bore the following superimposed rates (per \$100 of assessed valuation): county, \$.52; city, \$2.06; school district, \$2.18; forest preserve district, \$.11; sanitary district, \$.65; park district, \$.97, total tax rate, \$6.49.

Tax rates imposed on the assessed value of city properties vary widely. The range in 1927, for example, was from 12.471 per cent in Council Bluffs, Iowa, to 1.397 per cent in Washington, D. C. Because of prevalent underassessment, the rates on estimated "true" values were considerably lower; "true value" rates in 1927 ranged from 5.999 per cent to 1.11 per cent, with from 2 to 2½ per cent the common spread. Since the downward revision of property assessments lagged behind the fall of property values during the Depression, underassessment was considerably reduced. Furthermore, general shrinkage of tax revenues during this period forced most local governments to push their tax rates to the maximum permitted by tax rate limitation laws. Tax rates on "true" value of city properties during the 1930's were, in consequence, higher than those of any earlier period. Cities with populations over 100,000 showed 1939 "true" tax rates ranging from 1.08 per cent in Birmingham (Ala.) to over 4.85 per cent in Newark (N. J.) and Lowell (Mass.), with an average around 2.90 per cent.

Determination

Local property tax rates are of two kinds—mandatory "earmarked" rates and optional "general fund" rates.⁵

Mandatory special rates develop when counties or municipalities encounter strong demand for some special function—schools, roads, poor relief, and the like—and either wish to avoid the odium that would arise should they increase their "general fund" rates to cover the expenditure, or cannot raise their "general fund" rates because of constitutional or statutory limitations. The state legislature is persuaded to vote a mandatory "special" rate to finance the function in all counties or all municipalities. As many as a dozen manda-

⁵ In eighteen states, local rates on intangibles are established by state law and are uniform throughout the state. These classified property tax rates on intangibles are discussed on p. 406 of this volume.

tory special rates are to be found on the taxpayers' bills in some states. State universities and other state functions also are sometimes financed by state-wide mandatory rates.

Champions of special governmental functions, of course, enthusiastically support mandatory rates, since their functions are thereby freed of budgetary control by other local officials. And local officials generally approve, because with the costs of special functions removed, they can make a better showing with their "general fund" budgets. But authorities in Public Finance and Government unanimously oppose mandatory earmarked levies. Inevitably, it is argued, they breed an insidious, constant agitation for higher special rates, for splitting rates, and for new rates. They force the development of special functions in a pattern determined not by need for them, but by the productivity of an arbitrary tax rate in individual counties and municipalities. Ultimately they entangle the local authorities who, with most of their revenues earmarked, find themselves unable to develop effective accounting systems or to budget their resources wisely or effectively.

When, as in the past, governmental functions were limited in scope and the property tax was practically the sole source of local revenue, tax rates were determined simply by dividing the figure for estimated expenditure by that for assessed valuations. But not now, when local tax rates are pressing against statutory or constitutional limitations, or when an increase in tax rates may spell political suicide for the party in control of the government. City and county officials do not today make up a budget and then inquire what rate of taxation will be needed to balance it. First they note what funds will be available if the existing tax rate is maintained. They then endeavor to budget expenditures down to that limit. Even when they feel that popular opinion will accept an increase of the tax rate, they are still likely to think in terms of the *politically permissible* rate increase and what it will produce, rather than about the rate increase needed to produce a given revenue.

Many state governments, however, use property tax levies as an elastic balance in their tax systems. For the major part of their revenues they depend on such special taxes as income taxes, corporation

taxes, and so forth. Should the revenue from these special taxes temporarily decline below current needs, the state property tax rate is increased to cover the difference. If special state tax revenues expand temporarily, the state property tax rate is lowered or even abolished for a time. Several state constitutions specifically empower the state government to make such elastic use of general property tax levies.

Ordinarily, state and local property tax levies are voted as per cents or per mills on the assessed value of the taxable property of the state or district. In several states, however, instead of voting a property tax rate, the legislature votes a quota of revenue to be raised by property taxation. The amount of such a state levy is then distributed among the counties in proportion to their equalized assessed valuations, and is by them converted into tax rates to be applied to property valuations within each county.

Limitations

State legislatures, county boards, and local councils may not endlessly increase their property tax rates. Limitations are placed on state and local levies both by state constitutional and statutory provision.

Limitations on state property tax rates, found in nineteen states, are in every case stated as a maximum rate of so many mills on the dollar. The lowest limitation—one and one-half mills (two mills while the assessed valuation of the state was under \$900,000,000)—is found in Missouri, and the most liberal limitation—fifty mills on a half-value assessment—is found in Colorado.

Constitutional and statutory limitations on the levies of the counties and other local governments appear in all but the New England states and Maryland. The most common type of local tax rate restriction is the fixed limitation, varying usually between ten and twenty mills for each class of government—counties, first class cities, second class cities, school districts, and so forth. Such a millage limitation is frequently graduated according to the assessed valuation or the population of the governmental units affected. Occasionally this regular millage limitation may be exceeded upon referendum

or, under recent legislation, upon review by the state tax commission or other central control body. About a dozen states, instead of placing fixed millage limitations upon local levies, provide that any one year's levy must not exceed the levy of the preceding year by more than a fixed amount or stated proportion. Occasional instances occur of limitations of the total levy that may be made, or of limitations which fix a ratio between a local property tax levy and revenue received from other sources. Minnesota has an exceptional limitation providing a maximum levy per capita for each class of local government. Finally we should note that many states limit particular levies for specific governmental purposes, as well as the total levy for each class of government.

The most recent development in property tax rate restriction is the "blanket" or "overall" limitation applying not merely to the tax levies of particular classes of governmental units, but to the combined levies imposed upon property anywhere in the state. Beginning with West Virginia in 1932, powerful propaganda campaigns by organized real estate interests induced nine states to incorporate such "overall" limitations in their constitutions or tax laws. The Ohio limitation, most stringent of the nine, establishes a maximum of one per cent for the combined tax levies on any Ohio property.

Most fiscal economists speak in flat condemnation of all property tax rate limitation laws.⁶ Such limitations on local governments, which depend almost exclusively upon the general property tax, may become a fiscal straitjacket. If property tax rates imposed by local governments are restricted, but not their indebtedness, cities and other local governments hampered by tax rate limitations will resort to borrowing, even using money so obtained for current expenditures. A situation of this kind almost wrecked the credit of many Ohio cities some years back. If both tax rate and debt limitations are rigid, local governments may find it necessary, after a period of extravagance, to curtail highly desirable and even essential functions or improvements. After Ohio's one per cent "overall"

⁶ See Glen Leet and Robert W. Paige, *Property Tax Limitation Laws* (Public Administration Service, Monograph No 36, 1934). For an analysis favoring over-all limitations, see Lawrence G. Holmes, "Over-all Tax Limitation," in Tax Policy League, *Property Taxes* (New York, 1940), pp. 35-43.

limitation went into effect, many Ohio municipalities had to curtail their educational functions, and a few were forced to close their schools completely for a time. The chairman of the Illinois Tax Commission has summed up the case against property tax limitation laws in the following emphatic statement:

The experience of states experimenting with tax limitation schemes indicates: first, that tax limitation laws have not limited property taxes; secondly, that they have not accomplished the reformation of the state-local tax systems; thirdly, that they have produced neither economy in government nor a constructive avenue of approach to that goal; and lastly, that these schemes have so frequently curtailed governmental service and produced fiscal chaos that the plan has been permanently discredited. The conclusion is inescapable that the tax limitation plan is an unintelligent and ineffective method of accomplishing desirable results.⁷

But the issue is not entirely one-sided. For years economists have argued that local governments should break away from exclusive reliance upon property taxation. Some states have developed systems of sharing income, business, and other state-collected taxes between the state and the local governments. But in other states the inertia of the fiscal *status quo* was too powerful to overcome. It has been precisely in these states that the pressure for tax rate limitation laws by the real estate interests has been most persistent and most successful. As Professor Simpson writes of the recent campaign for "overall" rate limitations:

In many states powerful groups who are so situated that they are able to escape any heavy share of the general property tax but who would be subject to substantial income, inheritance, and other types of taxation, are sufficiently influential—financially and politically—to make any change from the present tax system practically impossible. In some states these are banking and financial groups; in some, manufacturing and industrial groups; in some, mining and utility groups; in others, various combinations of all of them. No matter what particular groups they may

⁷ Simeon E. Leland, "Probable Effects of Tax Limitation in Illinois," *Tax Magazine*, January 1935, p. 58.

be, their immediate interest lies in continuing the present general property tax and they are sufficiently powerful to block every proposal for genuine reform of the property tax and for the development of income taxes and alternative forms of revenue. . . . In many states these groups have been able to entrench themselves behind the "uniformity clauses" adopted nearly a century ago and the cumbersome methods of constitutional amendment by which most of the states are bound. They look upon these constitutional barriers as bulwarks against the adoption of . . . newer forms of taxation. . . . As a result of considerable contact with efforts in this field, I have come—somewhat reluctantly—to feel that rigid property tax limitation will prove to be the most effective dynamite for "cracking" these strata of vested interests and of opposition to reform that have accumulated about our present tax system⁸

COLLECTION

The last step in property tax procedure is collection. At first thought this might seem a simple, routine transaction from which no problems could arise. But, as will be seen, problems there are, and serious ones, for both the taxpayer and the administration.

Organization

In most states, all current property taxes—state, county, town, village, district, and any others—are listed on a single bill and collected by a single official. In some thirty states this official is the county tax collector or county treasurer; in a few instances another county officer—a sheriff or a trustee—is charged with the responsibility. Occasionally the collecting function is entirely in the hands of a local collector. And there remain a few states where each taxing district has its own collecting office, so that the taxpayers must make from two to six separate payments.

Time and manner

Property taxes are usually due and payable in a lump sum during the fall and winter months. The arrangement is hardly conducive

⁸ Herbert D. Simpson, "Effective Strategy for the Reform of the Tax System," *National Real Estate Journal*, October 1936, pp. 45-46.

to efficient financial administration by the tax-receiving government, and is highly inconvenient for business concerns and urban taxpayers generally. But it fits the farmers' financial arrangements neatly, for it is in the fall and winter seasons that they have cash on hand from the sales of their crops. Farmers' convenience was in the minds of the legislators when a half century or a century or more ago they first established property tax collection dates. Agrarian influence in the state legislatures and general inertia have maintained the uncomfortable arrangement down to the present in many states.

Every writer on the subject has recommended provision for installment payment of property taxes. The National Municipal League's model property tax collection law allows for payment in four installments. To date twenty-four states have amended their tax laws to the extent of authorizing local tax bodies to provide for two-installment or quarterly collection. New York in 1934 passed an interesting law authorizing the creation of loan corporations to pay property taxes in lump sums on the due date. Such payment is covered by the taxpayers' notes due at monthly intervals up to twelve months, and by a tax lien adhering to the property until the notes are fully paid. The corporations may charge a 2 per cent service fee, 4 per cent on the loan prior to maturity, and 6 per cent after default on any note.

Sending out annual bills, a routine business procedure, would seem an indispensable element of property tax collection routine. As far as can be discovered, tax offices of all large cities do send out bills.⁹ But in less than one-third of the states are rural collectors required to mail bills; in some others, bills must be sent on the taxpayer's request. Where they have the option, most county and local collectors apparently content themselves with a general published notice of the time and place for tax payment.

Delinquency and remedies

In one county, the firm application of effective tax collection laws by an efficient administrative personnel may in normal times produce complete or almost-complete collection of current levies as due. A

⁹ A sample property tax bill is reproduced in Appendix B, p. 806 of this volume

neighboring county having the same collection laws but less efficient administration may fail to collect one-tenth of its current levy. Even during the "normal" 1920's, particular districts in many states could be noted as having 25 to 50 cent delinquency ratios on their current tax levies. The average delinquency ratio for the country in 1928-29 was 6 per cent; at the depth of depression in 1932-33 it was 17 per cent.¹⁰ Urban delinquency is more widespread than rural; as of 1929, 150 cities with populations over 50,000 had an average delinquency ratio of 10 per cent, and for 1933 their ratio was 26 per cent. With the general improvement of business conditions after 1933, property tax delinquency declined; by 1938 the ratio for cities with populations over 50,000 was again down to 10 per cent.¹¹ Although the contrary might be found in individual districts and cities, as a general rule delinquency is greatest for undeveloped properties and small-value properties, lowest for stores, offices, and industrial properties.

Prior to the depression of 1929-33, no one considered property tax delinquency a serious problem. Penalties for late payment were charged as a fixed percentage of the delinquent tax, or as a high interest rate, or as a combination of both. With such penalties, half the delinquencies were paid up within a year, and rarely did more than a quarter of the delinquencies continue for over three years. Against continued and cumulated delinquency, the usual procedure was the "tax sale," at which liens for the amount of unpaid taxes, rather than the properties involved, were auctioned off. The purchaser paid the delinquent taxes, and received in return a lien against the property covering the amount paid plus interest and certain other charges. If within a specified period, the property owner failed to pay off the lien and extra charges, the lien holder either acquired title to the property subject to certain qualifications, or was given the right of foreclosure under the lien. Until 1931 the num-

¹⁰ Leo D. Woodworth, "Collection of Property Taxes with Special Reference to Real Estate," in National Tax Association, *Proceedings of the Twenty-Seventh National Conference*, 1934, pp. 330-354.

¹¹ Frederick L. Bird, *The Trend of Tax Delinquency, 1930-1938* (Dun and Bradstreet, New York, 1939).

ber of persistent delinquencies was sufficiently low and the market for tax liens sufficiently large to assure most governments of continuous full return on their tax levies.

From 1932 through 1934, property tax delinquencies reached crisis proportions. During 1933 delinquencies on current levies were in many cities running to 30, 40, even 50 and 60 per cent. In Michigan the *average* for the state in this year was 40 per cent. And a tremendous backlog was piling up. To have put all delinquent properties up for tax sale would further have wrecked the real estate market for many communities, might have led to vicious popular uprisings, and would have been useless anyway, since sufficient investment capital to buy all the tax liens involved was not forthcoming. Popular pressure forced the enactment of much "delinquency leniency" legislation—laws that extended the time of payment, reduced or waived penalties already accrued for delinquency, or postponed the date of tax sale—which, by inducing many who could have paid their taxes to hold them back, only made matters worse.

Depression experience directed popular and official attention to property tax delinquency, exposed it as a serious problem inadequately covered by existing law or administrative procedure. No single simple solution is to be sought. Evidence aplenty indicates that "current" delinquency—payment delays of a year or less—correlates closely with the inefficiency of collection procedure. Reasonable penalties firmly applied by an efficient collection office are the only cure here. Continued cumulated deficiencies in "normal" times are a sign either that a farm or business enterprise is economically submarginal (counting the tax as a normal cost item), or that it is in the wrong hands. In the first case provision must be made for its reversion to state or local government and its reincorporation into the public domain. In the second case, the way must be smoothed through better "tax sale" laws for its transfer to holders more capable of managing or sustaining it. For delinquent rent-producing properties a system of "tax receivership," under which the properties are administered by a public receiver, has been developed in Ohio, Illinois, and New Jersey.

PROPERTY TAX REFORM—THE CLASSIFIED PROPERTY TAX

In the course of the preceding pages, we have had occasion to consider many specific improvements of the property tax system. Many students of property tax problems feel, however, that these incidental patches on the property tax structure cannot cure its basic defects. Fundamental reform, not superficial correction, is necessary. Most popular reform proposal has been the classified property tax.

The principle of the classified property tax is the classification of taxable property for the application either of varying assessment ratios, or varying tax rates, or special *in lieu* taxes. According to the proponents of the reform, these assessment or rate discriminations, if properly adjusted, can eliminate many of the distributional injustices of general property taxation. Even more important, it is argued, property which seeks to evade the current high rates of ordinary property taxation would be listed for the low assessment ratios or rates of the classified tax.

History

Georgia offers the earliest example of the classified property tax thus defined. Her constitution of 1868 permitted the classification of property for tax purposes. In 1870, the city of Savannah provided for the taxation of real estate at $1\frac{3}{4}$ per cent and of intangible personalty at one-quarter per cent. This early attempt at a classified property tax was abandoned in 1877 and the Georgia constitution amended to provide for tax uniformity. Pennsylvania levied a three-mill tax on intangibles in 1879, and this application of the principle of the classified property tax has persisted to the present time. Connecticut, in 1889, replaced the general property tax on bonds, notes, and other documents of ownership with a registry tax. Rhode Island applied a four-mill tax to bank deposits in 1893. Maryland legalized classification in 1896.

From this time on, there are two trends to be followed in the development of the classified property tax. On the one hand, states constitutionally barred from levying classified property taxes

amended their constitutions to permit this form of taxation. On the other hand, a growing number of states empowered to levy classified property taxes actually embraced the reform. At the present time, thirty-five states have constitutions permitting property classification, and twenty of these levy classified property taxes. In six states the principle is applied fairly comprehensively to all forms of property. More commonly, only specified classes of intangibles are subjected to low mill rates or to recording taxes.

Classified taxation of realty

Classified property taxes are extended to elements of real property in but four states. Louisiana assesses the land and the factories of plants utilizing waste wood products at 10 per cent of their true value. Since the purpose of the special assessment ratio is neither to introduce greater distributive justice into property taxation nor to discourage property tax evasion, this is hardly an example of true classified property taxation. Rather, Louisiana's special assessment ratio is a sort of bonus to encourage a particular class of industry. True applications of the principle are the special assessment ratios applied to various classes of land in Minnesota and Montana,¹² and the varying limitations on the tax rates applied to three categories of real property in West Virginia. In Iowa, Minnesota, and West Virginia, special low assessment ratios or low rates are applied to homestead properties.

Classified taxation of tangible personalty

Six states—Kentucky, Minnesota, Montana, Ohio, Virginia, and West Virginia—apply their classified property taxes to tangible personalty. Their methods, however, differ widely. Virginia and Kentucky place special tax rates on elements of tangible personalty. In Virginia the rolling stock of railroads and motor carriers is taxed at 25 mills, and all other tangible personalty except tools and machinery at 7½ mills. Kentucky levies a five-mill state tax on agricul-

¹² Minnesota assesses unplatted land at one-third of its true value, platted land at two-fifths of its true value, and iron ore deposits at one-half of their true value. Montana assesses all land and improvements at 30 per cent of their true value.

tural products and further provides that county taxes on such property may not exceed $1\frac{1}{2}$ mills; machinery pays only the five-mill tax. Minnesota, Montana, and Ohio apply special assessment ratios to various categories of tangible personalty. Montana has established five categories,¹³ Minnesota four, and Ohio two. West Virginia accomplishes classification by setting varying rate limitations for three classes of personalty.

Classified taxation of intangibles

Thirty states still tax, or make a pretense of taxing, intangible personalty. Of these, twenty-one employ the classified property tax.¹⁴

By far the favorite method of subjecting intangibles to a classified property tax is the special mill tax. Louisiana and Montana alone apply special assessment ratios to particular classes of intangibles. Louisiana assesses corporation bonds at 10 per cent of their par value, while Montana assesses money and deposits at 7 per cent of actual value, bank shares and other moneyed capital at 30 per cent of their true value, and other intangibles at 40 per cent of their true value. As against these two, eighteen states and the District of Columbia tax specified classes of intangibles at special mill rates.

About half the latter apply their special mill rates to all classes of intangibles, while the others so tax only certain classes of intangibles. Where only particular classes of intangibles are subjected to special mill rates, the other classes are generally altogether exempt from property taxation. Thus, California completely exempts savings deposits or mortgages on local property from property taxation. Money and deposits are two classes of intangibles most commonly brought under the special mill rates. Business credits—bills and notes receivable—are also a favorite subject of the classified property tax. Special mill rates are less commonly applied to corporation se-

¹³ The proceeds of mines are taxed on their full value. Household goods, machines, motor vehicles, and boats are assessed at one-fifth of true value. Mining fixtures and supplies are assessed at three-tenths of true value. Live stock, farm implements, and stocks of merchandise pay on one-third of their true value. Other elements of tangible personalty are taxed on two-fifths of true value.

¹⁴ The most recent analysis is National Association of Assessing Officers, *Property Taxation of Intangibles* (Bulletin No. 21, 1939).

curities and mortgages; the former are usually altogether exempt from property taxation, and the latter are more often subjected to recording taxes. Uniform state rates on corporate excess and bank shares¹⁵ might also be considered an element of classified taxation of intangibles.

Special mill tax rates vary from the Massachusetts one-half mill tax on certain deposits which corporations make with the State Treasurer, to the Nevada eight-mill tax on solvent credits, "foreign" mortgages, and corporation securities. Sometimes a uniform mill rate is levied on all taxed intangibles, sometimes two or more mill rates are levied on as many classes of intangibles.

Recording taxes

In ten states secured debts are freed of annual property taxes and subjected instead to recording taxes. Mortgages, bonds, and other instruments brought under such taxes usually have no legal validity unless they are recorded with a designated state officer and the tax paid on the occasion of such recording. Not only does such recording validate the instrument, but it also accords exemption from regular property tax levies. The exemption may be effective either for a specified period of years, or for the life of the instrument while in the possession of the owner who recorded it. Recording tax rates may be fixed at so many mills on the dollar, or may, as in Minnesota and Oklahoma, be graduated according to the life of the recorded instruments.

Critique

In some respects, the accomplishments of the classified property tax would appear to sustain the claims of its proponents. Most states reported large increases in the assessments of intangibles following the introduction of low mill rates. Analysis of the per capita assessments of intangibles in general property tax states and in classified tax states shows considerably higher assessments in the latter group. And the same conclusion results from a study of per capita assessments of intangibles in cities. Without question, the application of

¹⁵ See pp. 384 and 385 of this volume.

low assessment ratios or low mill rates to intangibles increased, for a while at least, the amount of such property coming on the tax list.

But when attention is shifted from assessments to tax receipts, the picture is not so favorable. Increased assessments of intangibles which followed upon a change from a general property tax to a classified property tax were in many states more than matched by the consequent decrease in effective tax rates; tax revenues from intangible personalty fell off under the classified property tax. This condition prevailed in Connecticut, Iowa, Kentucky, Montana, Nebraska, and Oklahoma. Upon the advent of the classified property tax in these states, the tax burden on intangible personalty actually declined. In some of the other states, where the change to a classified property tax apparently resulted in increased tax yields from intangibles, contemporaneous improvements in tax administration deserved as much credit for the increase as did the changes in the character of the tax.

As Simeon Leland has pointed out, "the principal service of classification has not been as a fiscal measure to fill public treasuries but to provide greater justice and flexibility in the operation of the property tax."¹⁶ The general property tax posed a dilemma of equity—either intangible personalty escaped assessment and so did not bear its due share of property tax burden, or it was assessed at full value while other property was fractionally assessed and so had to bear an excessive burden. Without producing a revenue gain, and sometimes at a sacrifice of revenue, classification relieves this injustice.

Just as the highest hopes of classified property tax advocates have failed of realization, so also it must be recognized that the worst fears of its opponents have proved groundless. Removing the requirement of uniformity and proportionality, it was formerly argued, would throw wide open the door to favoritism in tax legislation. Property, it was charged, would be classified for low assessment ratios or for low mill rates with intent to favor special interests rather than for the general fiscal welfare. But except for some middle western states where agricultural products have been unneces-

¹⁶ Simeon E. Leland, "Some Observations Concerning the Classified Property Tax," in Tax Policy League, *Property Taxes* (the League, New York, 1940), p. 115.

sarily classified for low assessment ratios or tax rates, the predicted logrolling has failed to materialize to any marked extent. The classified property tax has been treated as an instrument of fiscal reform, and there have been few attempts to turn it to ulterior ends. Classified property taxation has introduced no new detrimental elements into the American system of property taxation.

PROPERTY TAX REFORM—ABOLITION OF THE PERSONALTY TAX

Because of the administrative difficulties of assessing tangible and intangible personal property, and the injustices arising from the taxation of such property, some fiscal writers have been led to argue for the complete abolition of personal property taxation and the transformation of the general property tax into a real property tax. To some extent this argument is in line with the current of events. Disappearance of the personal property tax has been a feature of European tax history. Fourteen American states so far have discarded their intangibles tax. Several, as we saw earlier,¹⁷ have dropped the taxation of tangible personalty. The movement has the support of the National Tax Association.¹⁸

Abolition of the personal property tax, or of a major portion of the tax, by itself would, it must be recognized, work a sharp injustice. Personal property, no less than real property, embodies tax-paying ability. Outright exemption of personal property would throw a disproportionate tax burden on real property. Clearly, the release of personal property from the burden of property taxation must be counterbalanced by the imposition of other taxes indirectly reaching personal property values.

Special business taxes and personal income taxes are most frequently suggested as substitutes for the personal property tax. Most business taxes, as administered by state officials, are free of the practical shortcomings which mark a locally administered personal property tax. Transfer from a personal property tax paid by business

¹⁷ See p 364 of this volume

¹⁸ For an opposing view, see J. L. Jacobs, "Exemption of Tangible Personalty," in Tax Policy League, *Tax Exemptions* (the League, New York, 1939), pp 141-154,

concerns to a special business tax changes somewhat the distribution of the tax burden. But this consideration does not condemn the transfer. It could hardly be argued that the burden of the personal property tax is so perfectly distributed that any change would have to be for the worse. Moreover, while the spirit of fiscal localism will not tolerate state administration of the personal property tax—which might give the tax some chance of success—it will permit a state-administered business tax to be substituted for the personal property tax. Unlike the property tax, which is looked upon as being of inherently local character, business taxes are generally viewed as elements of a state tax system.

The wisdom of substituting a personal income tax for the personal property tax paid by individuals is not so certain. A personal income tax is, in general, quite as difficult to administer as a personal property tax. In industrial states, where specialized tangible properties and intangible values are heavily concentrated, and where a large proportion of personal income is derived from business, investments, and salaries, the balance of administrative facility may favor the income tax. In agricultural states, where personal property is largely represented by such tangible elements as live stock and farm implements, and where personal income derives largely from farming, the difficulty of administering a personal income tax may exceed that of administering a personal property tax.

PROPERTY TAX REFORM—THE LAND VALUE TAX

A final school of property tax reformers would eliminate not only all personal property taxation but also a part of the realty tax. They would confine property taxation to the site value and the natural fertility value of land, and exempt all buildings and improvements. Land fertility and site values, they argue, are in no way the result of effort on the part of their owners. These are "natural" values which the owners are enabled to pre-empt because of the existence of the State and the body of law it supports. Land values are therefore felt to be a peculiarly suitable subject for taxation, in contrast to houses and factories, which result from the efforts of their builders. Furthermore, it is argued that relieving buildings and im-

provements from taxation and imposing additional burdens on land values, will check the holding of unimproved land for speculative purposes. By sucking all profit from such speculative holding, heavy land value taxes will force owners of unimproved land to build upon it, and thus aid the community's economic progress. Finally, proponents of land value taxes point out that taxes on land values generally rest on the owners, whereas taxes on buildings are shifted to the tenants of such buildings in the form of higher rent charges. Untaxing buildings and other improvements will ease the tax burden on the poorer classes of the community who rent their homes.

"Single Taxers" were the first active champions of the land value tax. One all-embracing tax on land values, they argued, would provide sufficient revenue for all governmental purposes; all other elements of state and local revenue systems could be dropped. But when the inadequacy of the general property tax as a provider of present state and local revenues is remembered, the impossibility of depending upon a land value tax as a single tax is self-evident. The impracticability of the single tax proposal, however, should not reflect upon the land value tax, which, of itself, deserves independent consideration.

Land value taxes have a history going back over fifty years in some of the Australian provinces and New Zealand. Recently a number of Canadian cities have attempted to rely upon land value taxes as single taxes. In the United States, various California irrigation districts, Houston (Texas), and Pittsburgh and Scranton (Pennsylvania) have experimented with the possibility of "untaxing" improvements. Mississippi, in 1926, provided for the exemption of all improvements on farm lands. Serious attention has been given to the suggestion for untaxing improvements in New York City and elsewhere.

Upon survey, land value taxes make a favorable showing when they are not levied as a single tax.¹⁹ Occasionally, the simultaneous "untaxing" of improvements and the imposition of additional taxes

¹⁹ See Harold S. Bottenheim, "The Case for Low-Rate Taxation of Improvements," in *Tax Policy League, op. cit.*, pp. 135-152. For a contrary view, see Jens P. Jensen, "Exemption of Improvements," in *Tax Policy League, op. cit.*, pp. 206-221.

on land values causes owners of unimproved land to rush improvements and the erection of buildings. The resultant false building boom may seriously weaken local real estate credits. Such an unfortunate result can be prevented if the change is inaugurated gradually as in Pittsburgh, where the "untaxing" of buildings and the shifting of the tax was spread over ten years. It should be noted, however, that the land value tax is susceptible of application only in urban regions where separate assessment of site value and of the value of improvements is possible. In rural regions, an assessor cannot separate the value of a farm into the value of its natural fertility and the value resulting from the labor of cultivation. Farm buildings may represent only a fraction of the value of labor put into a going farm. To "untax" the value of farm buildings, but to tax at a higher rate the value of improvements represented by soil cultivation, would deny the basic principles of the land value tax.

THEORETICAL CONSIDERATIONS

America has taken serious practical interest in property tax problems, but has been little inclined to explore its theoretical aspects. Whole libraries of information are available on the administrative features of the tax while a page or two at the most covers everything written on property tax theory. We have a few deductive generalizations on its incidence, a few incidental comments on its distributive effects. In part this paucity of theory results from the inherent complexity of the tax. In part it is a consequence of the wide variation of the tax as among states, with no archetypal levy available for analysis.

Incidence

On the basis of arguments advanced in Chapter XI,²⁰ were the property tax in any state truly a general property tax—were it a universal tax applying uniformly to all property values—we could state categorically that it was an unshiftable non-capitalizable tax. But, as we have seen, the so-called "general property tax" is in practice a series of special property taxes, sometimes at differing rates, on par-

²⁰ See p. 252 of this volume

ticular types of property. Some states tax real property only. Others tax realty and tangible personalty. Still others apply a uniform tax rate to realty, tangibles, and certain categories of intangibles. The twenty-one states with classified property taxes employ rates that discriminate between intangibles and other property. And finally, unequal assessment and evasion make property taxation anything and everything but "general." With these observations to guide us, we may lay down certain limited generalizations derived from our earlier consideration of the principles of tax incidence:²¹

(1) Taxes paid on property held for personal use cannot be shifted.

(2) Taxes paid on the natural fertility or site value of parcels of land cannot be shifted

(3) Taxes paid on business structures and personalty may be shifted by being incorporated in the prices of items produced through the instrumentality of the taxed property.

(4) Taxes paid on rented buildings and personalty may be shifted by being incorporated in rent charges, subject to the following qualifications:

(a) Long-term leases may block such shifting for considerable periods of time.

(b) In deteriorating neighborhoods, demand for rented quarters is not likely to press upon the available supply in a manner to permit a shifting of the tax.

(c) The alternation of speculative building booms and collapse may prevent the tax factor from becoming a price determinant in the actual real estate market.²²

Taxes on business properties involve three elements of discrimination which may interfere with tax shifting otherwise possible. Large business enterprises generally have relatively heavier investments in land and buildings than small concerns, which frequently rent their quarters. Consequently, large enterprises sustain an element of property tax burden not universally or proportionately

²¹ See pp 246-252 of this volume.

²² The following graphic illustration of this proposition is derived from Herbert Simpson, "The Incidence of Real Estate Taxes," *American Economic Review*, Vol. XXII, 1932, pp 224-225.

by the retail sales value of goods and services produced must be the rule rather than the exception as among competing business concerns. The concerns with the lightest relative property tax burden can generally shift their tax by incorporating it in the price of the goods or the services they sell. Heavier-taxed firms can increase their prices only in the same proportion as the lighter-taxed firms. Unless the group of heavier-taxed enterprises includes any large proportion of concerns operating around the no-profit margin, which would be driven out of business unless they succeeded in shifting all of their property tax burden, the heavier-taxed enterprises must bear the excess tax burden imposed upon them by the property tax.

Since American property taxes fall far short of being universal, to the extent that they are not shifted, they are generally capitalized—purchasers “buy themselves free” of all special tax burden by paying lower prices. Since a majority of properties change hands in the course of a decade, most present property owners, we may conclude, are bearing as a true burden only the tax increases of the past ten years. The burden of all earlier tax increases was loaded, in capitalized form, on the previous owners. Exceptions to this generalization may be noted where speculative optimism or a traditional inelasticity in land prices has interfered with tax capitalization, but these exceptions are not sufficiently numerous to shake the general rule.

Distributional considerations

According to Professor Simpson,²⁸ the justification first advanced for property taxation in the colonial and early federal periods was the “ability” theory. In those early times, with income-producing wealth mainly in the form of real property, it is quite probable that the property tax worked well as an “ability” tax. Toward the middle of the nineteenth century, however, land-owning opponents of the expanding functions of government turned to the benefit theory as an argument against their being taxed for the support of these new functions. Whereupon debate raged around the property tax

²⁸ Herbert D. Simpson, “The Changing Theory of Property Taxation,” *American Economic Review*, Vol. XXIX, September 1939, pp. 453-467.

as a "benefit" tax. Some argued that a tax on property distributes costs of government essentially in the same proportions as governmental benefits, which are primarily for property protection; others argued that the benefits of educational and social expenditures are distributed far differently from property tax burdens, so that the property tax is unjust from a "benefit" viewpoint. Now, according to Professor Simpson, the "benefit" phase of analysis has passed, and the property tax again finds its justification on an "ability" basis.

Upon examination, however, the "ability" argument for the property tax is revealed as being based on a false premise—namely, that individuals receive income in proportion to their property holdings. Contrast the present circumstances of many professional and salaried men whose incomes run into tens, even hundreds, of thousands of dollars, with the situation of "land poor" farmers—who own hundreds of acres of land but can barely wring a meager livelihood from them. Surely the former have greater "taxpaying ability" than the latter, yet the property tax passes over the salaried or professional man and presses with crushing weight on the farmer. Property might have been considered a fair measure of "ability" in colonial times, but it is an inadequate criterion today. Even if a property tax were truly "general," it would be far from perfect according to the criteria of tax distribution.

What is more to the point, the property taxes actually levied perpetrate serious direct distributional injustices. In some states, as previously stated, the law makes no distinction between such representative intangibles as mortgages or corporation securities, and the basic real and tangible properties which they represent. Some property values may, therefore, be taxed twice or even several times. No intricacy of legal fictions can disguise the fact that double or multiple taxation of particular properties, uncompensated by similar treatment of other properties, constitutes a serious economic discrimination. Furthermore, by law or in practice, many forms of property escape the property tax. Such properties are sometimes subjected to special taxes which take the place of the property tax, but often enough the escape is absolute. And notoriously, some properties are overvalued and others undervalued in the process of assessment.

Rate uniformity avails not at all when rates are based on unequal assessments. A uniform rate levied on unequal assessments results in unequal tax burdens.

In a community where there are no sharp inequalities in wealth and where the mass of property is of tangible, readily assessable character, the worst injustices of the general property tax do not develop. Tinkering and patching can soften the abuses that do arise. Given good administration, the general property tax may well prove a satisfactory method of taxation in states of essentially agricultural character. But as a community becomes more industrialized, as the distribution of wealth and income diverge, and as the intangible forms of property values increase in importance, the maladjustments of property taxation become ever more glaring.

CHAPTER XVII

Poll, Personal Income, and Payroll Taxes

POLL and personal income taxes have long been linked together in fiscal analysis as the two sole examples of personal taxation—taxes imposed on individuals as individuals. To these must now be added the new federal social security tax on employees' wages and salaries since it is, in effect, a special personal income tax. Such classification is highly arbitrary, for receipt of income is no more a characteristic of personal individuality than any number of other factors—ownership of property, for one. But, in default of any sounder functional classification of taxes, we shall accept the authority of precedent and bracket the three taxes.

POLL TAXES

The poll tax is a fixed sum levied on persons as persons. In the United States, it dates back to colonial times. Large landowners particularly, who saw in the poll tax an opportunity to shift part of the tax burden to the small landowners and the landless, considered it an especially just and appropriate form of taxation. But as variations in wealth and income increased, the poll tax was held to involve serious discrimination, to be baldly regressive in its economic effect, and to lack justification under both the benefit and the ability doctrines of taxation. Although criticism of the poll tax as a form of state or local taxation has never been hushed, the moderation of the levy has spared it serious legislative attack. Instead of disappearing from state and local tax systems, the poll tax has actually become more widespread during the past quarter century. State poll taxes during 1938-39 yielded \$8,500,000. Local levies produce around \$6,000,000 a year. In some southern states, the poll tax is a greater revenue producer than the income tax.

Present status

Poll taxes, generally reserved for local use, appear in three-fourths of the states. A few state governments, mostly in New England and the South, impose poll taxes. Sometimes the poll tax is exclusively a county tax, sometimes it is levied by villages or towns. Occasionally, independent poll taxes are levied by several classes of local governments in one state.

The poll tax is everywhere limited to adults. To prevent the application of the tax to persons probably without earning capacity, a maximum age limit, from fifty to seventy years, is commonly set. Women are subject to the poll tax in some of the states making such levy.

Special exemptions are frequent in the imposition of poll taxes. Soldiers and sailors, disabled individuals, paupers, the deaf, the dumb, the blind, and the insane are among the classes exempted.

Poll taxes are universally levied as flat charges, without graduation, and the tax is usually between one and three dollars. The highest charge, five dollars, is found in some Pennsylvania cities.

State and local poll tax revenue is occasionally treated as general revenue available for any and all governmental expenses. In most states, however, such revenue is earmarked either for school or road use.

Twelve southern states make payment of the poll tax a prerequisite for voting. No attempt is made to collect the tax from Negroes, and their failure to pay the tax is then utilized to bar them from the suffrage. In these states, payment of the poll tax by the whites has become a matter of racial prestige, assuring them continued political supremacy. The southern poll tax has lost most of its fiscal significance and has become an instrument of politico-racial regulation. Condemnation of this use of the poll tax by President Roosevelt aroused controversy in which the fiscal issue played practically no part.

Theory

Under the Constitution, the federal government cannot levy a poll tax unless it is apportioned among the states according to

population—a practically meaningless limitation. The only federal constitutional limitation on state or local poll taxation is derived from the “equal protection of the laws” provision prohibiting improper discrimination. But so moderate are the sums involved that cases on poll taxes rarely, if ever, reach the higher courts, and there are no leading decisions to indicate the attitude of the courts on the applicability of the “equal protection of the laws” limitation to poll taxation. Poll tax levies are made mandatory by the constitutions of a quarter of the states. In a few other states, on the contrary, they are flatly forbidden by constitutional decree.

Since the poll tax is levied on each individual as an individual, it relates to no class of business transactions which would permit its direct shifting. If a local poll tax were extremely heavy, the floating population of the locality might conceivably move to other, lower-taxing districts, and by leaving a labor shortage in the taxing locality, cause a wage increase there sufficient to cover the amount of the tax. But with poll taxes ranging between one and three dollars, the probability of shifting poll taxes by wage increases is very slight.

The poll tax finds no justification under any of the doctrines of tax distribution. Benefits of road and school maintenance for which poll taxes are usually levied can hardly be thought of as divided equally among the adults of the taxing district. Nor in these days of inequality in personal wealth and incomes can the adult individual be considered the norm of taxpaying ability.

At first glance, the administration of the poll tax seems extremely simple, since only a list of names is necessary for its collection. Nevertheless, evasion is surprisingly extensive. In the southern states, where poll tax payment is a prerequisite of suffrage, the fiscal element is subordinate to the political. Tax collection is pressed only where the dominant political party wants an individual to be registered as a voter. Poll tax administration is very imperfect even in other states. Individuals who own no property escape the assessor's eye, and the poll tax has tended merely to supplement the general property tax.

Critique

Poll taxes in the twentieth century are a fiscal anachronism. They offend every standard of good taxation, and the revenue therefrom is too small to justify the levy of a tax with such distributional shortcomings.

THE FEDERAL PERSONAL INCOME TAX

During the prosperous 1920's, the personal income tax was one of the mainstays of the federal tax system. The \$1,147,000,000 it produced in 1930 was but little less than the yield of the corporation income tax, many times more than any other tax or related group of taxes. But at the low point of depression in 1933, it produced a bare \$350,000,000. With the recovery and higher rates of the next four years, its yield mounted steadily. In 1937 it contributed \$1,092,000,000, 21 per cent of the total federal revenue. On the basis of increased "defense" rates imposed by the revenue acts of 1940 and 1941, and the rising level of national income resulting from the defense effort, it was anticipated that the yield of the federal income tax would pass \$2,000,000,000 and perhaps reach \$3,000,000,000.

History¹

American utilization of the personal income tax followed English experience with a sixty- to seventy-year lag. The first English income tax was imposed in 1799 as a fiscal incident of the Napoleonic wars. This levy was repealed at the conclusion of the war, but in 1842 the tax reappeared as a permanent element of the British revenue system. The first American federal income tax was imposed to finance the Civil War and was repealed within a decade; the tax entered as a permanent peacetime levy in 1913.

In 1861, as a war revenue measure, the federal government levied its first personal income tax. Initially the rate was 3 per cent on

¹ See Roy G. and Gladys C. Blakey, *The Federal Income Tax* (Longmans Green, New York, 1941)

incomes in excess of \$800, with special rates of $1\frac{1}{2}$ per cent on the interest from government bonds and 5 per cent on incomes going out of the country to nonresident Americans. Before returns were made under this act, the law was amended and the rates made progressive—3 per cent on incomes between \$600 and \$10,000, 5 per cent on incomes over \$10,000. Interest and dividends were taxed at 3 per cent, and the tax was collected at source.

In 1864 the rate schedule of the personal income tax was sharply raised. Rates on 1863 income were set at 10 per cent, 15 per cent, and 20 per cent. Along with other internal revenue levies, personal income tax rates were tapered off after the war, but because of the inflationary prosperity of the times, the yield rose until in 1866 it reached \$73,000,000. In 1867 the progressive rate schedule was dropped, and the tax became a proportional 5 per cent on all income in excess of \$1000. In 1870, the rate was reduced to $2\frac{1}{2}$ per cent, and the exemption raised to \$2000. Two years later the tax was dropped completely.

Again in 1894 the federal government experimented with income taxation. The Wilson tariff bill introduced in that year was expected to reduce customs revenue, and an income tax was attached to cover the anticipated deficiency. Although Senate amendments to the Wilson bill restored tariff protection and the probability of undiminished customs revenue, agrarian pressure was so insistent that the income tax proposal could not be dropped. The tax applied both to business and personal income, and the income concept included capital gains and inheritances. The rate was 2 per cent, with a \$4000 exemption for personal income. Before the tax could become fairly operative, however, the Supreme Court in two five-to-four decisions² held that a tax on the income derived from real or personal property was a tax on the property itself, hence a "direct" tax which must be apportioned among the states in proportion to population. With this decision, a federal personal income tax was impossible until either the Supreme Court reversed itself or the Constitution was amended.

Within two decades the Supreme Court did reverse itself on this

² *Pollock v. the Farmers' Loan & Trust Co.*, 157 U. S. (1895) 429, 158 U. S. (1895) 601.

very point.³ But meanwhile a constitutional amendment had been passed by Congress in 1909, and three-fourths of the states had ratified it by 1913. Its language was exceptionally direct and precise; it provided that

Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Thus authorized, Congress immediately enacted a personal income tax which was the progenitor, in direct line of descent, of the present federal income tax. Motivation for this 1913 income tax law was as much an intent to attack inequality of wealth and income as to provide the federal government with additional revenue.

The 1913 personal income tax was intended, unwisely perhaps, to complement the one per cent corporation income tax which had been imposed in 1909 and which was continued unchanged—dividend income would be taxed at source under the corporation tax, all other income would be taxed to the recipient under the personal tax. This linkage with the corporation income tax was responsible for the curious rate structure—the combination of “normal tax” and “surtax”—given to the personal income tax. The “normal tax,” from which corporation dividends were exempt, was established at the same rate—a proportional one per cent—as the corporation tax. In this way the corporation tax served as a partial collection-at-source arrangement for the personal tax. The “surtax,” to which dividends together with other incomes were subject, had a progressive rate schedule graduated from one to six per cent. Minimum exemptions on the “normal tax” were \$3000 for single individuals and \$4000 for married couples, the progressive “surtax” applied to incomes in excess of \$20,000.

In Professor Haig's words,⁴ the personal income tax established by the 1913 law was “a pious avowal of a vague ethical aspiration, replete with technical imperfections,” and rounded off with a perversely complicated rate schedule. The Treasury, the courts, and

³ *Brushaber v. Union Pacific Railway Co.*, 240 U S (1916) 1

⁴ In foreword to Roswell Magill, *Taxable Income* (Ronald Press, 1936).

Congress have labored to refine the measure. In addition to structural alterations, the federal income tax has undergone numerous modifications of its rate schedule, in accordance with the federal government's revenue needs. Of the many amendments to the personal income tax since 1913, we shall note at this point only changes in the rate schedule.⁵ The war revenue acts from 1916 on successively steepened the personal income tax rates. Minimum exemptions under the 1918 Revenue Act were set at \$1000 for a single person and \$2000 for a married person. The rate of the normal tax was 6 per cent on the first taxable \$4000, and 12 per cent on the remainder; the surtax was graduated from one per cent on the first \$1000 over \$5000 to 65 per cent on the excess over \$1,000,000. Between 1919 and 1928, seven reductions were made in federal income tax rates. Under the 1928 law, the minimum exemptions were \$1500 and \$3500, the normal tax was graduated from 1½ per cent to 5 per cent on the excess over \$8000, and the surtax was graduated from one to 20 per cent. Need for additional federal revenue during the depression years and for the Roosevelt "recovery" program resulted in substantial increases of the income tax rate schedule in 1932, 1934, and 1935. The "defense" revenue acts of 1940 and 1941 again lowered the personal exemptions and sharply increased the rate schedule. Salaries of state and local employees, excluded for constitutional reasons prior to 1939, were brought under the tax in that year.

Current status

Basis of the federal personal income tax is "net income," defined as "gross income" minus specified deductions.

"Gross income" includes all salaries, compensation, rent, investment income, business earnings, capital gains, and incidental profits received by individuals. Excluded for constitutional reasons are stock dividends and interest on state and local bonds. Interest on certain federal bond issues is exempt by statutory provision. While capital gains are taxable, the full amount is not always subject to

⁵ The course of legislation with respect to the taxation of capital gains is considered on pp. 434-438 of this volume; that on the "earned income credit" is covered on p. 443.

the tax. If the sold item was held more than eighteen months but less than two years, only two-thirds of the gain is taxable, or the total may be taxed at 15 per cent; for items held over two years, only half of the gain is counted for taxation, or the total may be taxed at 30 per cent.

Deductions from "gross income" include all business expenses, business and casual losses, bad debts, depreciation of tangible property used in business or yielding a return, and all taxes except federal income taxes. Contributions to organized religious, educational, and charitable institutions, up to 15 per cent of the taxpayer's total income, are also allowed as deductions. Personal or family expenses, capital expenditures on property personally utilized, and depreciation of property used for personal ends are not allowed as deductions. Capital losses, calculated on a basis related to capital gains, are also deductible.

Net income having been ascertained, certain further credits or deductions are allowed before the tax is actually calculated on the remainder. Under the 1941 law, every unmarried individual is allowed a personal exemption of \$750. Heads of families take a personal exemption of \$1500, and a \$400 additional exemption for each child or incapacitated parent or dependent relative. In calculating income subject to the normal tax, a 10 per cent credit is allowed on "earned income." By statutory definition, "earned income" includes wages, salaries, professional fees, and other personal compensation; all of an income under \$3000 is counted as earned; \$1400 is set as an arbitrary maximum for the credit. Prior to 1936, dividends received were not included in income subject to normal tax, though they were brought under the surtax; under the 1936 and subsequent income tax laws, they have been fully taxable under both normal and surtax.

The rate of the normal tax under the 1941 federal income tax law is 4 per cent. The surtax begins with 6 per cent on the first \$2000 of taxable income, and rises to 77 per cent on the excess over \$5,000,000. Application of the tax to incomes of varying sizes is shown in Table 25. Brutally heavy as these rates may appear to the American taxpayers who must pay them, for the lower and

TABLE 25
TAXATION OF INCOMES OF MARRIED PERSONS
UNDER FEDERAL PERSONAL INCOME TAX,
REVENUE ACT OF 1941

| Net Income | Normal Tax Rate Per Cent | Surtax Rate Per Cent | Highest Bracket Rate Per Cent | Total Tax | Per Cent Total Tax Is of Net Income |
|-------------------|--------------------------------|----------------------------|--|--------------|--|
| \$ 1,000 | | | | | |
| 2,000 | 4 | 6 | 10 | \$ 42 | 2 1 |
| 4,000 | 4 | 9 | 13 | 249 | 6 2 |
| 6,000 | 4 | 13 | 17 | 521 | 8 7 |
| 8,000 | 4 | 17 | 21 | 873 | 10 9 |
| 10,000 | 4 | 21 | 25 | 1,305 | 13 1 |
| 12,000 | 4 | 25 | 29 | 1,817 | 15 1 |
| 14,000 | 4 | 29 | 33 | 2,409 | 17 2 |
| 16,000 | 4 | 32 | 36 | 3,084 | 19 3 |
| 18,000 | 4 | 35 | 39 | 3,819 | 21 2 |
| 20,000 | 4 | 38 | 42 | 4,614 | 23 1 |
| 25,000 | 4 | 44 | 48 | 6,864 | 27 5 |
| 30,000 | 4 | 47 | 51 | 9,339 | 31 1 |
| 35,000 | 4 | 50 | 54 | 11,934 | 34 1 |
| 40,000 | 4 | 53 | 57 | 14,649 | 38 8 |
| 50,000 | 4 | 55 | 59 | 20,439 | 40 8 |
| 60,000 | 4 | 57 | 61 | 26,509 | 44 1 |
| 70,000 | 4 | 59 | 63 | 32,779 | 46 8 |
| 80,000 | 4 | 61 | 65 | 39,249 | 49 1 |
| 90,000 | 4 | 63 | 67 | 45,919 | 51 0 |
| 100,000 | 4 | 64 | 68 | 52,704 | 52 7 |
| 150,000 | 4 | 65 | 69 | 87,189 | 58.1 |
| 200,000 | 4 | 66 | 70 | 122,174 | 61 1 |
| 250,000 | 4 | 67 | 71 | 157,659 | 63 1 |
| 300,000 | 4 | 69 | 73 | 194,129 | 64 7 |
| 400,000 | 4 | 71 | 75 | 269,099 | 67 3 |
| 500,000 | 4 | 72 | 76 | 345,084 | 69 0 |
| 750,000 | 4 | 73 | 77 | 537,569 | 71 7 |
| 1,000,000 | 4 | 74 | 78 | 732,554 | 73 3 |
| 2,000,000 | 4 | 75 | 79 | 1,522,539 | 76 1 |
| 5,000,000 | 4 | 76 | 80 | 3,922,524 | 78 5 |
| over 5,000,000 | 4 | 77 | 81 | + | + |

The above computations are based on the maximum earned income of \$14,000, incomes of less than that amount are treated as all earned

middle brackets they pale by comparison with the war rates of the British income tax, which starts at $18\frac{3}{4}$ per cent on family incomes over £170, jumps in one small bracket to $37\frac{1}{2}$ per cent, and rises to 85 per cent on incomes over £50,000.

STATE PERSONAL INCOME TAXES

State income taxes were levied before a federal tax was ever considered. But without exception, all nineteenth century state income taxes were administrative failures, and their revenue yield was trifling. The story of effective state income taxation parallels that of the federal income tax, for only during the past twenty-five years have such taxes had an important place in state tax systems. As of 1941, thirty-five states and the District of Columbia had personal income taxes. In the previous year, state income taxes had yielded \$209,000,000.

History

"Faculty" taxes in the American colonies had a basis which combined both property and income. As previously described,⁶ the property element emerged dominant in most states, and "faculty" taxes gave way to the general property tax. In a few states the income element of the colonial "faculty" taxes persisted, and developed into rudimentary state income taxes. Personal income in Massachusetts, for example, was taxed under the general property tax rate throughout the nineteenth century. In South Carolina, income was assessed as an element of property until the Civil War.

The fiscal difficulties of many states after the financial collapse of 1837⁷ led to a wave of state income taxes during the 1840's. Pennsylvania levied a one per cent tax on salaries and a 0.1 per cent tax on other incomes in 1840. A year later Maryland levied a $2\frac{1}{2}$ per cent income tax. Virginia, North Carolina, Alabama, and Florida all imposed personal income taxes during the decade. These state income taxes of the 1840's were crudely administered, and only Virginia obtained an appreciable revenue from its tax.

During the Civil War, all the Confederate states and two border

⁶ See p. 361 of this volume.

states—West Virginia and Kentucky—enacted personal income taxes. Most of these taxes were limited to salaries and specific forms of personal income. But the administrative machinery provided was again inadequate. When the first flush of war enthusiasm had subsided, state income tax administration collapsed except in Virginia. Nevertheless, Louisiana and North Carolina, as well as Virginia, continued their income taxes through the century, but their laws were practically dead letters on the statute books.

In 1911 personal income taxes were still found in five states—Massachusetts still clung to its archaic “faculty” tax, Virginia and North Carolina had retained their Civil War income taxes, South Carolina had revived its income tax in 1879, and Oklahoma had levied an unsuccessful tax in 1908. All were administered by local property tax officials, none could claim the slightest shadow of success, and students of taxation at the time expressed great scepticism about the personal income tax as a possible source of state revenue. Wisconsin in 1911 opened a new chapter in American fiscal history with an income tax administered by a state tax commission. The rate schedule of this tax was progressive, beginning at one per cent over a moderate exemption and rising to six per cent on the excess over \$12,000. The success of the Wisconsin income tax was immediately apparent, and several other states were induced to enact income tax laws. Mississippi levied an income tax in 1912, Oklahoma followed in 1913, Virginia reformed its income tax on the Wisconsin model in 1916, and Delaware, Massachusetts, and Missouri joined the movement in 1917.

Federal and Wisconsin experience with income taxes demonstrated that a centrally administered income tax could be a practicable source of revenue. Scholars had long pointed to the income tax as a highly desirable form of taxation because of its close conformity to the principles of taxation according to “ability.” When with the advent of Prohibition the states lost their revenue from liquor licenses, many were compelled to tap new sources of state revenue. These three factors led to a small wave of state income tax laws immediately after World War I. New York, New Mexico, and North Dakota joined the group of income tax states in 1919,

North Carolina modernized its tax in 1921, South Carolina did the same a year later, and in 1923 New Hampshire enacted a special tax on the income from intangibles.

At the beginning of the 1920's, there were many who thought that personal income taxes would soon become a universal form of state taxation. But the movement which began with the New York and North Dakota taxes in 1919 soon waned. However, another wave of state income tax enactments began in 1929. Tennessee imposed a special income tax on income derived from stocks and bonds, and Arkansas, Georgia, and Oregon enacted general income tax laws. During the next decade, thirteen more states instituted personal income taxes. Many states which already had such taxes amended them, in most cases raising their rates.

Current status

Some similarity, and considerable variance, is found among the thirty-five state income taxes.⁷

New Hampshire's, Ohio's, and Tennessee's personal income taxes are not general income taxes, but special levies on income derived from intangibles. Salaries, business profits, rents, capital gains—all major items under a general income tax—are not reached. These special taxes apply only to interest from bonds and mortgages and dividends from stock. Colorado and Oregon, in addition to their general personal income taxes, impose supplementary levies on income from intangibles. Massachusetts has fashioned its tax, not as a single levy upon all personal income, but as a series of three complementary taxes on income from intangibles, on income from trading in intangibles, and on income from professions, employment, trade, and business; different exemptions and rates apply to each class of income. The Maryland and Vermont taxes have a somewhat similar structure. The other states, as does the federal government, levy the tax on the total of each individual's income.

There exists considerable diversity of jurisdictional bases for state income taxes. The special income taxes of New Hampshire, Massa-

⁷ An excellent summary is presented in Roy Blakey and Violet Johnson, "State Income Taxation," in *Taxes*, March-July 1941, pp. 131-136, 222-231, 280-286, 353-359, 422-438.

where taxed, also enjoy the benefit of these personal exemptions; in eight states, however, nonresidents are allowed personal exemptions only a pro rata basis.

The special income taxes of Colorado, Massachusetts, New Hampshire, Ohio, Oregon, and Tennessee all have proportional rates. So also does the general income tax of Maryland. Otherwise, the state personal income taxes all have progressive rate schedules. Compared with the rate schedule of the federal tax, the progression of the state income taxes is mild, and generally confined to the lower income brackets. A common arrangement is a one per cent increase in rate for each \$1000 or \$2000 of income, up to a maximum 5 or 6 per cent. Highest rates are found in Idaho where the tax reaches 8 per cent on income in excess of \$5000, in Oklahoma where it reaches 9 per cent on income over \$8000, and in North Dakota where it reaches 15 per cent on income over \$15,000.

THE INCOME CONCEPT

It is easy to assert that personal income taxes are based on "income." Definition of the term "income" is not so easy. Economists express widely divergent views on what "income" is and is not. Accountants have their own concepts. Legislators and tax administrators, more interested in workable practice than in theoretical consistency, have fashioned tax laws which involve arbitrary miscegenations of various economists' and accountants' concepts.

Our problem is not to give judgment in favor of one theory or tax provision as against another, but to analyze and understand the issues involved in the various income concepts.

Theoretical considerations

Economic theorists have offered many contradictory concepts of income.⁸ One group of writers⁹ applies the term "income" to the monetary value of the flow of services enjoyed by an individual

⁸ An excellent survey of economic writings on this issue is presented in Paul H. Wueller, "Concepts of Taxable Income," *Political Science Quarterly*, Vol. LIII, 1938, pp. 83-110 and 557-583, and Vol. LIV, 1939, pp. 555-576.

⁹ Of whom the most noted and most insistent American representative is Irving Fisher; see his "Income and Theory and Income Taxation in Practice" in *Econometrica*, January 1937, and "A Practical Schedule for an Income Tax" in *The Tax Magazine*, July 1937.

within a specified period of time. Another group¹⁰ views income as the monetary value of the net accretion to an individual's economic power within a specified period of time, with no deduction for his personal expenditures. A third group¹¹ takes the much narrower view that income consists of recurrent, consumable receipts.

Under the "service-flow" concept, an individual's net income would be equivalent to his expenditures for current personal and family consumption, plus the estimated monetary value of his "psychic income"—the services enjoyed from such durable properties as an owned home, house furnishings, and an automobile, and the value of the uncompensated labor of the individual and members of his family for their own comfort and welfare. Since funds devoted to savings and investment purchase no personal utilities or satisfactions, they constitute no part of "service-flow" income. The amount and character of receipts during the income period are irrelevant; a millionaire miser who spent \$1500 a year on living and hoarded the rest of his receipts would have exactly the same "income," under the "service-flow" theory, as an unemployed man who lived for a year upon \$1500 drawn from his savings account.

The "economic-accretion" concept considers only the receipt or accrual of purchasing power to the individual. In addition to personal compensation, rents and royalties, interest, net business profits, and dividends, this concept includes capital gains and losses, bequests and gifts, and "psychic income." What disposal the individual makes of his income after it is his—whether he spends it, saves it, invests it, or gives it away—has no bearing.

The "recurrent-receipt" concept also looks to the receipt rather than the disposal of income items. But it limits income to recurrent items—personal compensation, rents and royalties, interest, net business profits, and dividends. Nonrecurrent items—capital gains, bequests, and gifts—are excluded.

American income taxes, federal and state, rest essentially upon

¹⁰ Of whom the most frequently cited American representative is Robert Murray Haig, see his *The Federal Income Tax* (Columbia University Press, 1921), p. 27.

¹¹ Of whom Carl Plehn may be taken as the leading representative, see his "Income as Recurrent, Consumable Receipts" in *American Economic Review*, Vol. XIV, 1924, pp. 1-12.

the "economic-accretion" and "recurrent-receipts" concepts. But they deliberately ignore certain items which the economists regard as "income." In the interest of administrative expediency, the taxes do not apply to "psychic income." Since a special form of taxation has been built up around bequests, inheritances, and gifts, these items are also eliminated from personal income taxation. And under the federal tax, capital gains and losses receive special treatment.

"Psychic income," mentioned above, has enjoyed considerable prominence in fiscal-economic literature, and deserves special discussion. Assume that *A* owns a house, rents it for \$2000 a year, and himself lives in another house for which he pays \$2000 rent a year, while *B* owns a house which could be rented for \$2000 a year but which he chooses to use for his own dwelling. Accountants credit *A* with a \$2000 income, and *B* with none. Economists argue that *B* has obtained benefits from living in his house which exactly balance the \$2000 rent *A* received from him, *B* has received a "real" or "psychic" income exactly equivalent to *A*'s monetary income. Similarly, a farmer who consumes his own produce receives a "psychic income" equivalent to the sales value of that produce. So also, a man who builds his own house, and a housewife who does her own cooking and housekeeping, receive "psychic incomes" from their labors equivalent to the cost of having those operations performed for them by others.

Occasional attempts have been made to take account of "psychic income" in American income taxes. The federal Civil War income tax and the Wisconsin tax of 1911 provided that the rental value of premises inhabited by the owner should be listed as income. Such provisions were admirable as incidents of economic theory, but they proved administratively impracticable; evasion was too easy, and compulsion of payment in individual cases that came to the administrators' attention provoked exceptional resentment. So our current income taxes ignore "psychic income," with consequent discrimination between individuals and groups of taxpayers. The man who lives in a rented home is discriminated against as compared with the man who lives in his own home. The family doing

its own housework and laundry is favored as against the family which employs servants and patronizes commercial laundries. Farmers are favored, because as a class they own their own homes and consume their own produce. As a class, dwellers in the larger cities are subject to discrimination since they employ and pay others for domestic and personal services to a greater extent than the inhabitants of small cities and suburban rural regions.

Capital gains and losses

An ever-open issue in income taxation is the treatment of capital gains and losses. Are such gains and losses properly brought within the income concept, or should they be considered capital manifestations which never touch the income plane? If they be considered an element of income, should they, as a matter of expediency, be brought within the scope of a personal income tax? If they are taxed, should they be accorded special treatment, and what should that treatment be?

Capital gains and losses would be completely separated from income under the "recurrent-receipt" theory of income; the English income tax which rests on this theory does not extend to "nonrecurring profits." Just as positively, however, the "economic-accretion" doctrine would include them in income. American legislatures accept the "economic-accretion" doctrine on this point; in sustaining them the Supreme Court has added the proviso that the gain or loss must be "severed" or "realized" before it assumes the attributes of income.¹²

Although the majority economic opinion and the decisive legal opinion in this country accept capital gains and losses as an element of income, subjecting such gains and losses to income taxation faces a number of criticisms. First and foremost, it is argued that a man whose property or investment has increased markedly in value hesitates to sell it and take his profit because of the heavy tax which results. This hesitancy to realize taxable capital gains, it is further argued, slows the tempo of business and investment transactions. The consequent retention of such properties is a factor in capital

¹² *Eisner v. Macomber*, 252 U. S. (1920) 189.

inflation, and leads ultimately to losses when a downswing of the business or financial cycle causes capital values to decline. As a generalization this argument can be neither proved nor disproved. Probably it is an operative factor in individual cases. But whether these cases are sufficiently numerous to exercise any appreciable effect on the capital and investment markets cannot be determined.

Another criticism of capital gains taxation is that, in periods of rising capital prices, many of the gains subjected to the tax are illusory—they represent only an enhancement in the *prices* of the properties sold rather than any gain in their basic *values*. Likewise, capital losses allowed as deductions against taxable income during periods of falling capital prices are not true losses but mere monetary variations. In periods of sharp capital inflation or deflation, this is a serious defect of the capital gains tax. In ordinary times, when swings of capital prices, while present, are moderate, the practical injury is not serious. Application of a “capital price index number” to taxable gains and losses, it has been suggested, would eliminate this defect. But a satisfactory “capital price index number” has yet to be computed. And even were such an index number available, its use in connection with income taxation might produce administrative difficulties which would make the cure worse than the imperfection to be corrected.

Another charge brought against the capital gains tax is that it makes the yield of an income tax highly variable. Toward the end of a period of rising capital values, realized capital gains are large and a capital gains tax may produce tremendous revenue. After a persistent decline of capital values, realized capital losses far outweigh realized capital gains, and a gains tax becomes a fiscal liability. Thus in 1928 the federal capital gains tax produced \$576,000,000—almost as much as the tax on current income; in 1931, capital loss deductions resulted in a net \$89,000,000 reduction of the \$335,000,000 tax that would otherwise have been paid on current income. Such irregularity of yield in a major tax is a sadly upsetting item in a revenue system.

Finally, if the accruals of a capital gain over several years are lumped in the particular year when the gain is realized, the appli-

cation of a progressive rate schedule results in overtaxation. Suppose a \$20,000 capital gain accrued over twenty years at the rate of \$1000 a year. Under the present rate schedule of the federal income tax but without the present provision for application of the tax to only half the gain on long-held property, such a gain realized in a lump sum at the end of the twenty-year period by a taxpayer who had no other taxable income would be taxed 24.1 per cent. But had each year's \$1000 capital gain been taxed as it accrued, even under the present rate schedule the tax on the total capital gain would have been only 9.4 per cent, since it would be subject only to the minimum bracket rate each year. Except for taxpayers in the wide-range upper brackets, whose lumped capital gains might be within a single bracket, this principle holds true at all levels of income. And lumping capital losses in the year they are realized also works against the taxpayer's interest, since the saving reaches further into the lower income brackets subject to lower rates. Were the loss deductible as it accrued each year, the saving would appear as a yearly reduction in top income brackets upon which the tax is heaviest.

Proponents of capital gains taxation admit most of these criticisms, but argue that they are outweighed by other considerations. Capital gains, they insist, generally represent unearned increment or—in the case of corporate shares—undistributed profits never taxed to the shareowners as income. By all principles of tax justice, such receipts are peculiarly appropriate objects of taxation. They might, with some reason, be excluded from personal income taxation, and be brought under a special capital gains or capital increment tax. But since special gains or increment taxation has not been developed in the United States—and, in the case of the federal government, probably could not be developed because of constitutional limitations on the federal tax power—capital gains and losses should by all means be brought under the personal income tax. Although the yield of a personal income tax is made widely variable by including capital gains and losses in the income concept, for as long as the population and wealth of the nation continue to expand, such inclusion will add to the long-term yield of a per-

sonal income tax. American legislators have evidently been persuaded by these considerations, for capital gains and losses are brought under the federal income tax and under all general state income taxes except those of Iowa, Maryland, and South Dakota.

Bringing capital gains and losses under an income tax does not close the issue of capital gains taxation. Still to be answered is the question of *how* to treat gains and losses under an income tax. Some of the many possibilities of capital gains taxation, the uncertainty of opinion, and legislative indecision on the matter are illustrated in the sequence of provisions for reporting of capital gains and losses under the federal income tax:

1913-1917. capital gains treated like other income; capital losses deductible only against gains.

1917-1921 capital gains and capital losses treated like other income.

1921-1924. capital gains on assets held over two years may be taxed at $12\frac{1}{2}$ per cent at option of taxpayer.

1924-1932 provision for capital gains unchanged; capital loss deduction may not reduce tax rate on amount involved by more than $12\frac{1}{2}$ per cent.

1932. capital losses on securities held less than two years deductible only against gains on holdings under two years

1933. carry-over of short-term losses abolished

1934: special $12\frac{1}{2}$ per cent rate abolished; percentage of capital gains, ranging from 100 per cent where assets held less than one year, to 30 per cent where held over ten years, included with current income; similar percentage applied to calculation of capital losses; deduction of capital loss limited to amount of capital gain plus \$2000; no carry-over of losses

1938. three percentage classifications, from 100 per cent to 50 per cent, instead of five under 1934 law; maximum tax rate or reduction for assets held 18 to 24 months is 20 per cent, for assets held over 24 months 15 per cent; \$2000 net loss allowance eliminated for assets held under 18 months.

State treatment of capital gains and losses shows the widest imaginable variation. The general tendency is to tax capital gains on transactions undertaken for profit at regular income tax rates, though there are instances of special or fractional rates. Capital

losses are generally allowed as a deduction, but frequently such deduction may be made only against gains reported for the year or during a two-year period. Several states follow the federal government in counting only fractional parts of capital gains or losses according to the length of time that the property was held.

The optional 12½ per cent rate on capital gains allowed under the federal income tax from 1921 to 1934 was designed to reduce the injustice of applying high-bracket rates to realized gains which might have accrued by small increments over a long period of time. Also, it was hoped, it would weaken the inducement offered rich men to avoid a heavy capital gains tax by retaining investments which had increased in value. Probably this flat rate capital gains tax was helpful in both directions, but it was criticized for benefiting merely a handful of rich individuals. As of 1929, for example, only taxpayers with current incomes over \$100,000, less than one-quarter per cent of the total number, benefited by the 12½ per cent capital gains rate; they alone would have had to pay more than 12½ per cent on capital gains counted as ordinary income. The fractional method of calculating capital gains and then bringing them under the regular income tax schedule, provided in the 1934 tax, accomplished the same results as the earlier flat rate tax and benefited small and large taxpayers alike.

All "justice" arguments lead to the conclusion that if capital gains are added *in toto* to other taxable income, capital losses should be allowed as a deduction against other income. And if in any year capital losses exceed other income, some crediting arrangement should be made to reduce income tax liability for later or earlier years. In this instance, however, principles of justice have been subordinated to fiscal necessity; such deduction provisions would cancel a large element of taxable income in depression years and sharply reduce the yield of the entire tax. Several states limit the deduction of capital losses to the amount of reported capital gains; the federal government formerly allowed \$2000 above reported gains for the year. At the sacrifice of taxpayers having more deductible losses than taxable gains, income tax yields for these governmental units are thereby sustained in depression

periods. But the injury is not as serious as might appear at first glance. In the course of a year, most investors can so combine sales involving loss with sales involving gain that realized gains are available against which to credit losses.

Tax-exempt income

In federal income tax and most state income tax laws, taxable net income is defined as "gross income" less certain "deductions." Then, in a catch-all sentence or paragraph, "gross income" is defined in such a way as to cover practically all current and profit receipts an individual might receive in the course of the year. Two classes of receipts—certain non-income receipts, and certain items of income nontaxable because of contractual or constitutional reasons—are excluded.¹³ For social reasons, some states also exclude certain other classes of receipts.

Excluded non-income receipts listed in the federal income tax law are life insurance and casualty insurance payments, damages for personal injury, annuities up to the amount previously paid in plus interest, and gifts, bequests, and inheritances. The logic of these exclusions is obvious.

As elsewhere explained,¹⁴ the federal income tax was long held to be inapplicable to the compensation of state or local employees or to the interest on state and local securities; a corresponding exemption from state income taxation was extended to the compensation of federal employees and the interest on federal securities. In addition, by the terms of issue, interest on Treasury bonds until recently has been exempt from the federal normal tax although subject to the surtax, and interest on other federal securities and on Federal Farm Loan issues has been excluded from both normal and surtax. Many states likewise exempt from their income taxes the interest on their own state and local bonds. The constitutional prohibitions against taxing state and federal instrumentalities have recently been weakened if not eliminated by Supreme Court de-

¹³ Sample federal income tax returns showing the calculation of gross income and deductions are reproduced in Appendix C, pp 807-813 of this volume.

¹⁴ See pp 209 and 219 of this volume.

cisions The federal personal income tax now extends to the compensation of state and local employees, and the state taxes now cover federal salaries. Still untouched by the federal tax, in spite of strong recommendations by the Treasury Department, however, is the interest on state and local bonds; nor have the states applied their personal income taxes to interest on federal bonds, though they have successfully reached such interest by other taxes. Extension of the federal tax to interest on state and local securities has been heatedly debated in and out of Congress during the past few years;¹⁵ all indications point to legislation in the near future providing for reciprocal taxation by the federal government of interest on *new* state and local issues and by the states of interest on *new* federal issues At the rates of the 1938 federal personal income tax, such extension of the tax would have yielded in time, when interest on the entire volume of state and local debt was taxable, an additional \$200,000,000 to \$300,000,000 annually; at present federal tax rates the yield would, of course, be much higher. Significantly, in 1941 the federal Treasury began issuing its bonds fully subject to federal taxation.

Most common "social" exemption under income tax laws is the rental value of a residence furnished to a minister by his congregation, it appears in the federal tax and in seven of the state taxes. Several states exempt pension receipts. North Dakota excludes interest on savings bank deposits.

Note also that twenty-three of the states having general personal income taxes exclude dividends paid by corporations already taxed by the state. As we have seen, prior to 1936 the federal statute exempted dividends from the normal tax though not from the surtax. This exclusion of dividends from personal income taxation is a survival of the theory that a personal income tax and a corporation income tax are one single tax with two complementary levies, rather than two separate taxes. The corporation tax has been viewed as a loose method of collecting at source the personal

¹⁵ See 76th Cong, 1st Sess, Special Senate Committee on Taxation of Governmental Securities and Salaries, *Hearings* (1939) The general problem of tax-exempt bonds is discussed on pp 682 ff of this volume.

tax due on dividend income. This theory of income taxation has waned, to the extent of utter discard in the federal tax law. Probably many states which now exclude dividends from their personal income taxes will also, in the near future, eliminate this exclusion.

Deductions

Personal receipts are in many cases *gross* rather than *net* income—various costs are incurred in obtaining the receipts. Particularly is this circumstance marked in the case of personal income from business activities, where the net profit—the true net income—may be only a small fraction of the total receipts. All personal income tax laws provide for the deduction of these costs. Theoretically only costs associated with the *earning* of income should be deductible, costs involved in spending this income for personal purposes should not enter the income concept. In general the income tax laws adhere to this distinction. Occasionally, as we shall see, the line cannot be clearly drawn between the two, and tax laws are generous in allowing possible expenditure costs to be deducted together with income costs.

The federal income tax law specifically allows as a deduction from gross income “all the ordinary and necessary expenses paid or incurred during the taxable year in carrying on any trade or business.” All general state income tax laws either copy this wording or cover the same idea with different phrasing. Likewise, all income tax laws provide that additions to reserves for depreciation and depletion shall be counted as a deductible cost, thereby opening a dispute between taxpayers and administration. What initial value shall be allowed for the depreciating property? What shall be the rate of depreciation allowed upon it? Unless general rules are modified by wide administrative discretion, they are certain to be arbitrary and to do injustice in individual cases. Under the corporation and personal income taxes of the 1920's, the federal tax administration was apparently very liberal in its concession of depreciation allowances. During the 1930's, to increase the yield of the tax, it arbitrarily stiffened its policy.

Bad debts, interest payments, and tax payments are generally

allowed as deductions irrespective of whether they arise out of business or personal transactions. One class of interest—that paid on loans to carry tax-exempt investments—is not deductible under the federal law and under most state laws. Were this deduction permitted, a convenient avenue of tax avoidance would be provided for many taxpayers. Nor does the privilege of tax deduction extend to all taxes. Neither the federal government nor the states permit the deduction of their own income or death taxes. Many state income taxes do not allow the deduction of federal income tax payments.

Both federal and state laws have always allowed current business losses as a deduction against other income. Two issues are associated with this deduction. First, should the loss deduction be limited to the current year or, other offsetting income being insufficient, should it be allowed against income earned in subsequent years? From 1921 until 1932, the federal tax law permitted losses to be carried forward for three years; in 1932 the “prior year loss” period was reduced to two years, and in 1933 the carrying forward of losses was ended. Seven states allow a one- or two-year “prior year loss” carry-over. Another approach to this problem, as yet not incorporated in legislation, would be to base the tax on a running average of the income of three prior years. The second issue is whether losses on operating business property should be treated as a capital loss or come under the provisions for current business losses. No distinction is necessary, of course, where no special rate or computation treatment is applied to capital loss deductions. But, as we have seen, the federal government and some of the states accord special treatment to capital losses. Their treatment of losses on operating business property has varied considerably; present practice is to consider them capital losses.

No economic theory of income can justify allowing contributions to religious, charitable, scientific, and educational organizations as deductions. Motivation of this class of deductions is an ulterior consideration—the intent to stimulate such contributions for the social advantages they produce. To safeguard the revenue against contributions, the deduction is limited to a specified proportion of

taxable income—to 10 per cent by a few states, to 15 per cent by the federal government and most states. Some states allow the deduction only for contributions made to organizations operating within the state.

Earned income credit

From 1924 until 1932, and again from 1934 to the present, the federal income tax authorized a special deduction, a credit to be allowed against "earned income"—an individual's compensation for personal services actually rendered, as distinguished from income derived from property or invested values. Three arguments have been advanced in support of this credit. First, the labor for which the compensation is given, it is asserted, involves the disutility attached to most economic efforts; to arrive at the "clear" value of the income to the recipient, this disutility should be deducted as a "cost." Secondly, productive capacity is a sort of human capital which may be said to depreciate with age and use, until with old age or death it disappears altogether; "earned income credit" may then be considered a depreciation allowance, similar to that granted other machines and capital equipment. Finally, it is argued, since wages, salaries, and professional compensation vary more than returns on investment, some allowance should be made to offset the disadvantages of this variability.

Admirable in theory, the "earned income credit" suffers from practical shortcomings. When a business man both owns and manages an enterprise, no sharp line can be drawn between "earnings" on his managerial activities and investment return on the capital value of the business. When a famed executive receives a million-dollar salary from a supercorporation, it is impossible to determine what part represents payments for his efforts, and what part is an investment return on the publicity value of his name to the corporation. As a consequence, the federal tax law must make an arbitrary, artificial definition of "earned income." The present law establishes two categories of "earned income"—"wages, salaries, professional fees, and other . . . compensation for personal services actually rendered" up to \$14,000 a year, and a "reasonable allow-

ance" on the net profits of an owner-managed business enterprise not exceeding \$14,000 or 20 per cent of the business profit. On "earned net income" so constituted, the credit deduction is 10 per cent up to a maximum of \$1400.

Most commentators point out that the effect of an "earned income credit" need not be obtained by an arbitrary income tax deduction. A progressive income tax schedule is in itself a loose tax discrimination against "unearned" income, since the proportion of income derived from investment returns is larger in the higher-taxed net incomes of rich individuals than in the lower-taxed incomes of poorer individuals. Furthermore, if other elements of a tax system impose special tax burdens on property, since the net return on such property is reduced, the investment or "unearned" income is correspondingly burdened. To the extent that they are not shifted, state property and business taxes have this effect

CHAPTER XVIII

Poll, Personal Income, and Payroll Taxes

(Concluded)

PERSONAL INCOME TAX RATE SCHEDULES

WHEN the federal personal income tax was under debate a quarter of a century ago, the issue of proportional or graduated rate was bitterly contested. In conservative quarters, the principle of progression was still denounced as "confiscatory" and "un-American." Today the overwhelming body of popular and critical opinion not only accepts, but approves progressive income taxation. The federal tax has had a graduated schedule since its inception in 1913, and all the general state income taxes, except Maryland's, likewise have progressive rate schedules. We may now ignore as no longer pertinent the old basic controversy over the inherent propriety of progression in income taxes, and devote our attention to more specific problems arising out of personal exemptions, to the formulation and application of graduated rate schedules, and to the minor point of property tax offsets.

Personal exemptions ¹

The federal income tax allows a \$750 "personal exemption" to single persons, a \$1500 exemption to "heads of families," and a further \$400 exemption for each minor or incapacitated dependent. These exemptions are the lowest ever provided in the federal income tax: during World War I the "married person" exemption was lowered to the \$2000 level, and the single person exemption stood at \$1000. Through the 1930's, the federal personal exemption was \$1000 for single individuals and \$2500 for married taxpayers.

¹ The fullest analysis of the issues involved in personal income tax exemptions is Paul J. Strayer, *The Taxation of Small Incomes* (Ronald Press, New York, 1939).

Personal exemptions under the state income taxes range from \$1500 and \$3000 in Alabama to \$600 and \$1100 in South Dakota. In Arizona, Iowa, Minnesota, South Dakota, and Wisconsin, the "personal exemptions" are covered by deductions from the tax instead of by deductions from the net income itself.

Four arguments are advanced in support of the personal exemption. First, provision of the necessities of human life is as much a "cost of production," it is asserted, as any of the business costs allowed as deductions; an individual's "clear" net income does not begin until the minimum costs of living have been covered. Second, under "ability" arguments, it can be reasoned that a person or family has no "taxpaying ability" whatsoever if income just suffices to cover minimum living expenses. Third, from a social point of view, it is not desirable that an income tax force a person or family to adopt a "submarginal" living standard. And finally, personal exemptions reduce the number of returns under the tax, and hence lessen the administrative costs.

Prior to 1942, exemptions under the federal income tax were considerably above the minimum-of-subsistence level—a basic assumption for the first three of the above four arguments. State income tax exemptions are generally still liberal. The earlier federal and current state exemptions represent a "minimum-of-comfort" exemption. This liberality is in conformity with American views of fiscal propriety and arouses little criticism. About the only argument directed against minimum-of-comfort exemptions is that they cause the income tax to become a class imposition, and relieve a majority of the population from any sense of financial responsibility for the conduct of their governments.

This latter argument led to the proposal, embodied in the National Tax Association's model tax plan, that fairly high personal exemptions be allowed in order to simplify income tax administration, but that every individual or head of a family be required to file either a return showing the amount of his income or a certificate stating his income to be below the exemption amount. To the filing of the return or the certificate would be attached a fee of five or ten dollars. Requiring a return or a certificate from

every recipient of income would facilitate the tracing of numerous petty tax evaders who escape at present because the tax administration has no record of their existence. Furthermore, since every individual would be compelled to contribute directly to the government, it would instill "tax consciousness" and impress every individual with the importance of economy in government affairs. Finally, it would assure the taxing government of a not inconsiderable item of revenue. Filing fees of this character were associated for a while with the personal income taxes of Delaware and Utah; political pressure soon forced their repeal in both states.

Debate over the "defense" revenue acts of 1940 and 1941 revived the issue of the size of personal exemptions. There was widespread agitation for "broadening the income tax base"—i.e., lowering personal exemptions and thus increasing the number subject to the tax. The three principal arguments for such action were (1) the revenue, running into several hundred million dollars, that would result from a substantial cut in the existing exemptions; (2) the awakening of "tax consciousness" on the part of several million new taxpayers, which might lead to pressure for more economy in federal expenditure; and (3) the absorption of a substantial element of purchasing power, which would help check the inflation threatened by other elements of the defense finance program. Congress heeded the agitation in 1940 to the extent of reducing exemptions from \$1000-\$2500 to \$800-\$2000. The general reaction to this step was that under the circumstances the cut should have been more substantial. In 1941 the exemptions were lowered to \$750 and \$1500.

Taxation of nonresidents upon income originating within the taxing state raises a special problem with respect to personal exemptions. No line of reasoning can justify allowing the nonresident to deduct the full amount of the personal exemption from the fractional part of his derived income. Nevertheless, a substantial proportion of the states taxing nonresidents allow them full personal exemptions. A few states, with greater logic, prorate the personal exemptions in accordance with the proportion of total income derived within the taxing state. Two states have adopted the inde-

fensible compromise of granting the single-person exemption to nonresidents, irrespective of their family status.

Application of progression

The federal and state income taxes accomplish progression by the "bracket" method.² Furthermore, "continuing" exemptions and the federal "earned income credit" substantially reduce the effective burden of the scheduled rates. Actually, therefore, the over-all rates on total incomes are considerably lower than the maximum "bracket" rates applying to these incomes. Under the federal tax from 1926 until 1931, for example, the top bracket rate on taxable incomes over \$100,000 was 25 per cent, but the taxes actually paid on these incomes averaged only between 13 and 17 per cent.³ As of 1932, when the top bracket rate for incomes over \$1,000,000 was 63 per cent, such incomes paid an average tax of 47 per cent. A comparison of bracket rates and actual burdens under the 1941 tax was shown in Table 25.

From a federal revenue viewpoint, the most important incomes are those in the so-called "middle brackets"—between \$10,000 and \$100,000. Individuals with small incomes report a much greater total of income, but the generous personal exemptions allowed leave little of the reported income subject to taxation, and then only at the lowest rates. Wealthier persons who report larger incomes subject to heavier rates are relatively few in number—for prosperous 1928 only 16,000 incomes over \$100,000 were reported, for unhappy 1932 only 1,836. The bulk of the yield of a federal personal income tax is determined largely by the rates applied to "middle bracket" incomes. If the rate schedule progression is swift and severe, so that even incomes between \$10,000 and \$25,000 pay heavy rates, the tax will be a big revenue producer. With the same top rate but with "delayed" progression, the truly heavy rates would apply only to incomes over \$100,000, and the yield of the tax would be fractioned. Confiscatory rates on superincomes may be mere

² See p 298 of this volume.

³ If tax-exempt income, charitable contributions, and other proper and improper methods of tax avoidance were taken into account, the burden of federal income taxes paid on incomes actually received would be considerably lower.

social window dressing—not a single income over \$5,000,000 to be subjected to a top-bracket 79 per cent rate was reported for 1936.

In state income taxation, the revenue importance of the different income groups varies. The concentration of wealthy individuals in the eastern industrial states makes the yield of a personal income tax dependent to considerable extent on the rates applied to large incomes. Rates applied to small incomes are of greater importance in agricultural states.

The federal normal tax and surtax

The separation of the rate schedule of the federal personal income tax into two elements—a normal tax and a surtax—derives from the early idea that a corporation tax is not primarily a tax on business, but a supplement to a personal income tax, a method of collecting part of a personal income tax at source instead of from the recipient. Originally the rates of the federal corporation income tax and of the personal income normal tax were identical. A person's dividend receipts were exempt from normal tax since they had already paid the same rate under the corporation tax. But the corporation levy could not take into account progressive rate elements determined by the size of individual incomes, and dividend receipts were made subject to the progressive surtax. The distinction between normal tax and surtax, established to cover the peculiar features of dividend taxation, was utilized for other purposes. Interest on certain federal bond issues was made exempt from normal tax but not from surtax, and the earned income credit was allowed only on the normal tax.

Within a few years, however, the theory that the federal corporation income tax was supplementary to the personal income tax was dropped, and the corporation levy was regarded as an independent business tax. In 1917 the corporation tax rate was set at 6 per cent, while the normal personal tax rate was set at 4 per cent. Thereafter until 1936, there was no equivalence between the federal corporation and the personal normal tax rates, so that the exemption of dividend income from the normal tax was meaningless. In 1936 the dividend exemption was abolished. Consequently, the continued distinction

between a proportional normal tax and a progressive surtax cannot be viewed as other than an anachronistic, cumbersome survival. A single rate schedule would be easier for taxpayers to understand, simpler for the Bureau of Internal Revenue to audit. The earned income credit and the few remaining elements of "partially exempt" interest could be adjusted to a single rate schedule without particular difficulty.

Limits to progression

Constitutionally nothing prevents the federal government or any of the states from establishing 100 per cent rates on income over a prescribed amount. Nor does economic theory dictate any maximum rate for income taxes. But the graduation of income tax rate schedules is not purely a matter of legislative indiscretion. Certain fiscal circumstances place loose limits to income tax progression.

Graduation in state income taxes is limited by two considerations. With the rates of the federal tax rising to 79 per cent, were state taxes that allowed no deduction for federal tax payments to be higher than 20 per cent, they would result in complete confiscation of income in excess of some figure. More potent is the consideration that, if the top-bracket rates of a state income tax are set even moderately high, wealthy individuals will avoid the tax by moving to lower-taxing or nontaxing states. For a number of years, Florida and Nevada have advertised themselves as income-taxless havens for millionaires, and boast that they have already attracted many wealthy residents from other states. Their success would be correspondingly greater if top-bracket state income tax rates were higher than they are.

The federal government does not have to fear the exodus of millionaires because of high income tax rates. National residence is not changed as lightly or as easily as state residence. None the less, progression in the federal income tax is limited, although by a different set of factors. Let the top rates of the tax be set too high, and recipients of larger incomes will find it advantageous to shift their investments from corporate securities to tax-exempt government issues. As top-bracket rates approach confiscatory levels, the incen-

tive to evasion and avoidance is heightened, for the gain to be derived is increased. Expert legal talent hopefully or despairingly suggests all sorts of "dodges"—incorporation of private yachts and racing stables so that the costs of operation can be counted as deductible current business losses, creation of trusts for relatives and dependents so that the income devoted to their support shall no longer be credited to the taxpayer, formation of partnerships between husband and wife or father and sons to split up a single large income and remove it from the higher tax brackets, and innumerable others.

Some of these tricks are disallowed by the courts and the taxpayers are compelled to pay full tax, but many prove to be valid "loopholes," and provide an avenue of escape until "plugged" by subsequent legislation. Somewhere along the line as top bracket rates are pushed higher and higher, a "law of diminishing productivity" comes into operation, and the tax yield from the high income brackets falls off with further rate increases.

Property tax offsets

Many states first levied their personal income taxes as substitutes for their unworkable intangible property taxes or even to replace an entire system of personal property taxation. Usually the intangibles tax was abolished forthwith. But Wisconsin in 1911, and later other states, adopted the policy of maintaining the tax on personalty together with the personal income tax, allowing the former as an offset to the latter.

Criticism of property tax offsets has been severe. A careful analysis concludes with the denunciation:

the off-set operates not only in a capricious way, dependent upon arbitrary ratios of income and property, but introduces a positively vicious element in the redistribution of burdens which it brings about ⁴

Such criticisms are based upon the argument that through these offsets some individuals are able to reduce their income tax pay-

⁴Herbert D. Simpson, *The Effects of a Property Tax Off-set under an Income Tax* (Institute for Economic Research, Chicago, 1932), p. 53.

ments more than others. They overlook the point that whatever is saved on the income tax is paid under the property tax. From a broader view, the offset is a reasonable combination which reaches the two elements of ability based on income receipt and property ownership. Furthermore, the offset arrangement operates to establish a minimum revenue for property income taxation, reducing the wide variability of the income tax yield. The primary count against the property tax offset is that it involves double administrative organization and procedure to collect a single item of revenue.

CONSTITUTIONAL LAW OF PERSONAL INCOME TAXATION

Under the Sixteenth Amendment, the federal government is specifically empowered to tax income without apportioning the tax among the states according to their respective populations. Curiously enough, it may be questioned whether the power of the federal government to levy an unapportioned personal income tax is really dependent on this amendment. In two early cases,⁵ the Supreme Court held that the Civil War income tax was an excise, an indirect tax, and need not be apportioned. The famous *Pollock* cases⁶ did not decide that a federal income tax as a whole is a direct tax, but only that a tax on income derived from property is equivalent to a tax on the property from which such income was derived. Hence, to the extent that the federal income tax applied to income derived from property, it was a direct tax and had to be apportioned. A generation later, however, the Supreme Court found a federal corporation income tax to be an indirect tax, and by applying the subject-measure rule, sustained all income elements included in the measure of the tax.⁷ Later still, the argument of the earlier court in the *Pollock* cases was flatly condemned.⁸ Constitutionally, therefore, it would appear that the federal personal income tax could be sustained as an excise upon the receipt of income. Under the author-

⁵ *Pacific Insurance Co. v Soule*, 7 Wall. (1868) 433, *Springer v U S.*, 102 U. S. (1870) 586.

⁶ *Pollock v Farmers Loan & Trust Co.*, 157 U. S. (1895) 429, 158 U. S. (1895) 601

⁷ *Flint v Stone Tracy Co.*, 220 U. S. (1911) 107

⁸ *Brushaber v Union Pacific Railway Co.*, 240 U. S. (1916) 1.

ization of the Sixteenth Amendment, it is imposed as a direct tax on income. But this constitutional authorization for federal income taxation covers only such receipts as the courts construe to be income; stock dividends, which have been construed by the Supreme Court to be a non-income item, may not be brought under the federal income tax.⁹

Despite the Sixteenth Amendment which gives the government power to tax income "from whatever source derived," a certain class of income was long held to be nontaxable under the personal income tax. Until the late 1930's interest on state and local bonds, and the salaries of state and local officials and employees were generally believed to be beyond the reach of a federal levy, state income taxes had to extend a corresponding exemption to interest on federal bonds and to federal salaries.¹⁰ Then, in a rapid succession of cases beginning in 1938, the Supreme Court shattered the federal and state instrumentalities limitations with respect to salaries.¹¹ Many authorities believe that the way has been cleared as well for taxation of the interest on state and local securities.

Where the "equality" and "uniformity" provisions of state constitutions are not construed to prevent state income taxation, a state income tax may be imposed directly upon income as such, or may be levied as a tax on persons "measured by" the incomes they receive. But since a state has no jurisdiction over the persons of nonresidents, a state income tax whose subject is persons could not well be extended to the income derived by nonresidents from within the taxing state. Therefore, state income taxes specifically or impliedly have "net income" for their subject. The federal Constitution imposes no bar to the taxation of nonresidents' income originating within the taxing state,¹² except for one limitation—state income tax rates and exemption provisions must not discriminate against nonresidents.¹³

⁹ *Eisner v Macomber*, 252 U S (1920) 189

¹⁰ Although under the "subject-measure" rule, state bank income and corporation income taxes were applied to interest on federal securities—see pp 521 and 511 of this volume

¹¹ See pp. 209 and 221 of this volume

¹² *Shaffer v Carter*, 252 U S (1920) 37

¹³ *Travis v. Yale & Towne Manufacturing Co*, 252 U. S. (1920) 60

JURISDICTIONAL BASIS FOR PERSONAL INCOME TAXATION

Under constitutional law, the federal government and the states have full power to tax all income received by residents,¹⁴ and all income originating within their boundaries. Which of these two bases or what combination of them will be employed, is determined by the discretion of Congress and the state legislatures. Congress has chosen to rest the federal personal income tax on both bases, allowing a credit to citizens for foreign income taxes paid on the basis of origin, and allowing a reciprocal credit to alien residents for foreign income taxes paid on a nationality basis. In effect, therefore, the federal tax is primarily based upon origin. For the most part, as we have seen, the states employ both bases, with some provision for reciprocal credits.

Critical opinion predominantly favors residence as the basis for personal income taxation; the National Tax Association's model tax plan contemplates residence-basis state income taxes.¹⁵ On "benefit" arguments, it is admitted, a case can be made out for taxation of personal income both by the state of the recipient's residence and by the state of the income's origin. The former protects and serves the recipient in his personal capacity. The latter protects the property from which the income originates and fosters the business which produces it. But as personal income tax rates are currently applied, residence-basis taxes conform to "ability" principles and origin-basis taxes do not. A progressive rate schedule has justification under "ability" doctrines only when it is applied to the entire income received by an individual or family group; residence-basis taxes permit such application of progressive rates. When progression is applied to the accidental segments of individual incomes which chance to originate in one state or another, it lacks this justification. Given two identical incomes, such "segmentary" progression

¹⁴ Until recently, it was doubtful whether a state could tax income which a resident derived from real estate located in another jurisdiction. The issue has been settled in the affirmative by *Cohn v. Graves*, 300 U. S. (1937) 308.

¹⁵ *Proceedings of the Twenty-Sixth National Tax Conference*, 1933, p. 365. But see Tax Policy League, *The Place of State Income Taxation in the Revenue Systems of the States* (1935), p. 10, for recommendation of origin-basis state income taxes.

results in lower taxes on income originating in several taxing states than on income originating entirely within one state.

This defect of origin-basis income taxes might be cured by determining the tax rate on a segment of "origin" income by the taxpayer's total income. The rate so determined would then be applied to the "segment" of income derived within the taxing state. Let us assume that a state's income tax rate schedule is one per cent on the first \$4000, 2 per cent on the next \$4000, and 3 per cent on the excess. Of a total \$10,000 income, \$5000 originates within the state. The rate determined by the total \$10,000 income is 1.8 per cent. This would be applied to the \$5000 of "origin" income. The constitutionality of a similar arrangement in the case of state death taxes has been upheld by the courts¹⁶. Should the issue ever be presented to the Supreme Court, approval of this arrangement might well be extended to state income taxation. A combination of origin-basis income taxes levied by several states, with each state determining the rate on its segment of "origin" income by the individual's total income, would result in fair comparative tax burdens as among the individuals. As compared with residence-basis taxes, the one serious disadvantage of origin-basis income taxes is the added administrative load resulting from the multiplicity of returns on segmented incomes.

A fair and sound system of state income taxation can be developed either on an origin or a residence basis, but not on a combination of the two. If some states employ the one basis and some the other, or if states seek to augment their revenues by employing both bases at once, unjustifiable double taxation of the incomes of some individuals is bound to occur. When but few American states levied personal income taxes, the occasional instances of double taxation could be ignored. Now that over two-thirds of the states have income taxes, scores of thousands are likely to be victims of double taxation.

Reciprocal credit clauses are included in the income tax laws of most of the states taxing on both residence and origin bases. Under these reciprocal arrangements, eleven states allow credit to residents

¹⁶ *Maxwell v. Bugbee*, 250 U. S. (1919) 525.

for income taxes paid in other states; seven of these, and five others, allow credit to nonresident taxpayers for taxes paid to the state of residence. But while reciprocity clauses dispel the injustice of double taxation, they leave the administrative authorities burdened with nonresident returns upon which little or no tax is paid. If the system of reciprocal credits becomes general—as seems likely—its necessity as a retaliatory weapon against states which selfishly maintain their double tax bases will disappear. A single residence basis for state income taxes is a probable eventuality.

PERSONAL INCOME TAX ADMINISTRATION

Administration is the keystone of effective income taxation. If the administration fails, the tax must fail—as state income taxes did fail until Wisconsin showed that capable administration was possible.

For all the justifiable and unjustifiable criticism aimed at the activities of the federal Income Tax Unit, it has developed a superb technique. And many states can also boast now of noteworthy accomplishment in this field.

Collection-at-source v. information-at-source

From an administrative point of view, personal income taxes may be divided into two broad categories—those collected at source, and those paid by the individual receiving the income. Essentially, the “collected-at-source” tax is paid by the individuals or business concerns from whom the recipient obtains the various items of his income. In practice, a “collected-at-source” income tax operates as a series of complementary special income taxes. One tax—on salaries and wages—is paid by employers. Another, levied on corporation dividends and the interest on registered bonds, is paid by the corporations issuing the shares or bonds. Still another tax rests on royalties, rents, and similar payments, and is paid by the tenants. The tax on other classes of income is paid by the recipients themselves.

“Collected-at-source” taxes operate on the theory that the payer of an item of income, unlike the recipient, has little interest in concealing it from the tax collector, and hence evasion will be reduced.

Furthermore, the "collected-at-source" tax enjoys a psychological advantage. Since the taxpayer is not compelled to pay out funds actually in his possession, he does not suffer a direct deprivation which might arouse his resentment. But on the side of practical disadvantage is the impossibility of applying a progressive rate schedule to a series of special income taxes. Introducing progression by a surtax on all income reported by the recipient, as in England where the "collected-at-source" income tax has had its fullest development, surrenders all the advantages claimed for the "collected-at-source" tax.

Arkansas, Kentucky, and New York authorize the tax on a non-resident's income to be collected at source if the administration is persuaded that it might be evaded. American income taxes are otherwise collected from the recipients. Evasion is forestalled by checking data reported against information received from the sources of income payment.¹⁷ Employers must report to federal and state tax authorities the salaries of employees earning more than the amount of personal exemption. Corporations are compelled to report dividend and interest payments. Information on other sources of income is also obtainable. Although the tax administration is put to an additional labor of correlating return and source data, this labor would also be required were a progressive surtax levied together with a "collected-at-source" basic tax.

Assessment

Personal income taxes may be assessed in two ways—by the taxpayer himself or by the tax administration. The federal income tax, and all state income taxes except Massachusetts', are self-assessed taxes. Each taxpayer reports the component elements, positive and negative, of his income, and in addition calculates the figure for his taxable income, applies the rates of the tax schedule to it, and determines the amount of tax due.

Two essentials to the success of a self-assessed tax are tax forms as simple and nearly self-explanatory as ingenuity can construct, and

¹⁷ A sample "information" return form is reproduced in Appendix C, p. 807 of this volume.

a foolproof set of directions. For a long while the federal Treasury overlooked the point that most of the complexities entering into the calculation of large incomes are not present in the millions of small incomes covered by the bulk of tax returns. The taxpayer with a \$3000 income had to plow through a return form planned to cover the possibilities of a \$3,000,000 income. For directions, the bewildered taxpayer was given excerpts from the tax law or from official regulations, couched in language more likely to confuse than to enlighten. Happily, the Treasury officials have in recent years given thought to the problems of the "little" taxpayer, and have provided him with simplified forms and directions. With some lag, the states are following the lead of the federal Treasury.¹⁸

Calculation of income tax liability under the Massachusetts law involves difficulties which the legislature believed beyond the ability of the average taxpayer to solve. Consequently the Massachusetts taxpayer is required only to prepare a statement of his income and its various sources, the tax administration makes actual calculation of the tax. The disadvantage of the Massachusetts system is the additional administrative labor necessitated. It has compensating advantages, however, since it compels a celerity of handling tax reports which is sometimes missing in the administration of self-assessed income taxes.

Audit, check, and review

From 3,000,000 to 8,000,000 personal income tax returns, half of them reporting taxable income, are submitted to the federal tax authorities every year, and proportionately larger numbers—because of lower personal exemptions and the application of state income taxes to nonresidents—to the state administrative agencies. Manifestly, searching inquiry cannot be made into every one of these returns. In federal procedure, all returns for \$5000 income or less are verified as to their mathematics in the collectors' offices, cross-checked with information returns, and thereupon relegated to the files. Occasional individuals—one in every forty or fifty—are called

¹⁸ Samples of federal and state income tax return forms are reproduced in Appendix C, pp. 808-821 of this volume.

to a collector's office for a browbeating about a questionable listing of a dependent or a suspicious bad debt deduction, more for the moral effect of indicating that the office is alert than for the amounts of revenue involved. Between three-quarters and four-fifths of federal returns are thus summarily disposed of. State tax units accord similar brief treatment to small returns.

Returns for incomes over \$5000, between 350,000 and 1,000,000 a year, are subjected to a more intensive audit by the internal revenue agents who cooperate with the collectors. If any change in tax liability is made, the taxpayer is notified and allowed opportunity to confer with the agent. Prior to 1938, tax disputes not settled at such conferences were referred to the "technical staff" of the Income Tax Unit at Washington, and subsequent hearings and reviews were conducted there; now, members of the "technical staff" are distributed among the regional offices, and the higher stages of review are handled through these offices. Cases where the taxpayer and the "technical staff" fail to reach agreement go into litigation before the Board of Tax Appeals.

Penalties

Substantial penalties are necessary to induce income taxpayers to file their reports when due and to report their income fairly. The federal government exacts a penalty of 5 per cent per month, up to a maximum of 25 per cent, together with 6 per cent interest, for failure to file returns by the due date. Where intent to defraud can be proved, the courts may in addition assess fines up to \$10,000 and impose terms of imprisonment. State penalties, in general milder than the federal, vary widely.

Innocent understatement of income on a tax return is rarely punished, the tax laws being content with an interest payment on the deficiency. Where "negligence" is established as a cause of the understatement, the interest charge is usually higher. Fraudulent understatement is punished even more severely. Under the federal law the taxpayer must pay an additional 50 per cent penalty tax, and may be sentenced to fine and imprisonment. Many of the state

laws provide a 100 per cent penalty tax for fraudulent understatement.

Evasion and avoidance

A self-assessed tax like the personal income tax might appear at first glance an easy one to evade by willful nonstatement or understatement of income items and willful overstatement of deduction items. And so it is, if administration is casual. But where administration is effective—where a serious audit is given at least to larger returns, and where suitable penalties are enforced without favor or prejudice against all offenders—deliberate evasion of a personal income tax is reduced to moderate proportions. It is likely to be rare among recipients of large incomes because of the more careful scrutiny devoted to their returns and the heavier penalties that they would incur. Taxpayers in the lowest brackets may indulge in considerable concealment of minor items of income apart from their salaries and may exaggerate their deductible expenses, but the global total of all their petty deceptions constitutes but a trifling reduction of the total revenue from a sharply progressive tax.

Avoidance—utilization of legal loopholes to effect tax savings within the letter though contrary to the spirit of the law—rather than evasion, has been the great difficulty with the personal income tax. Income tax avoidance during the past quarter century has assumed a multitude of ingenious forms. The most common method is the purchase of tax-exempt securities with funds not actively employed in business operation or business control; interest on such securities is, of course, wholly or partially exempt from federal income taxation. The yield on these securities is lower than on corresponding taxable investments, but the difference in yield is much less than the tax saving for wealthy individuals whose incomes are subject to the higher bracket rates. Since both the federal and state governments have given active sanction to such tax saving by specifically providing bonds exempt from their own as well as each other's taxes, no shadow of moral disapprobation can attach to taxpayers who profit by this method of tax escape; many writers, indeed, object to applying the term "avoidance" to investment in tax-exempt securi-

ties. All other methods of income tax avoidance heretofore employed can be reduced to three basic types: (1) short-circuiting the flow of income into expenditure or investment so that it did not appear as realized income of the taxpayer; (2) establishing fictitious deductions; and (3) fictionally fractioning a single large income among a number of apparently independent recipients so that high bracket rates were avoided.

Short-circuiting income so as to sidetrack the taxpayer was accomplished by inserting corporations between the taxpayer and some element of his income. One method was to incorporate an expensive hobby—an estate, a yacht, a racing stable. The taxpayer would transfer to such a corporation investment securities to provide it with a gross income sufficient to cover the expenses of the hobby. Thus he freed himself of an item of income that otherwise would have been taxable to him under the personal income tax. Since the expenses of the corporation—maintenance of the estate, or yacht, or racing stable—ate up all the return from its invested capital, there was no net income to be subjected to corporation income taxation. And, of course, such corporations could declare no dividends to add to the taxpayer's taxable income. A second method of short-circuiting income was to incorporate a "personal holding company" to which the taxpayer transferred his investments. Such part of the income of these corporations as consisted of dividends on the stock of other corporations was formerly nontaxable under the corporation income tax; income consisting of interest on bonds was taxable as corporation income at a much lower rate than the higher bracket rates that would have applied to the taxpayer's personal income. The taxpayer could then borrow his living expenses from the personal holding company without incurring any personal income tax liability whatsoever, while the company reinvested all the excess over such borrowings as the taxpayer personally would have done.

These "short-circuit" loopholes in the federal income tax have been closed in two ways. The federal courts have looked behind the fiction of the "expenditure" corporations, and have upheld the Bureau of Internal Revenue in taxing the income of these corporations directly to the taxpayers for whose benefit they operate. The

"personal holding company" loophole has been plugged by a special penalty surtax on such corporations—65 per cent on the first \$2000 of a personal holding company's undistributed net income, and 75 per cent on the excess over \$2000.

Some short-circuiting of income is still possible where a wealthy individual or a group of wealthy men control a regular business corporation and utilize their control power to restrict its dividend declarations. Thus their taxable dividend income is reduced, and the corporation employs its undistributed income for further investment. The undistributed profits tax of 1936 was directed in part towards this element of avoidance. With the abolition of that tax in 1940, the only present check on the practice is a 25 to 35 per cent surtax on corporations "improperly accumulating surplus", this penalty surtax is, however, very difficult to apply and is practically a dead letter.

Establishing fictitious deductions also had many possibilities, of which we shall note only two. Investments which had declined in value from their original purchase price, but which the taxpayer still wished to retain, were extensively used to establish "capital losses," which could be deducted from other income or from realized capital gains, according to the provisions of the statute. A "wash sale" would be effected—the securities would be simultaneously bought and sold, through different agents, at the current market price. Or they would be sold to a member of the family. Or they would be sold to a friend, with an arrangement for subsequent repurchase at the same price. Thus a loss was established for tax purposes, while the taxpayer retained ownership or at least control of the securities involved. Another brilliantly ingenious technique for establishing fictitious interest payments was worked out and actually applied some years ago. An insurance company was incorporated in Bermuda with no requirements as to capitalization, reserves, or procedure. Rich men were then solicited to take out life insurance policies for fantastic amounts. Premium payments would be covered by loans from the company; interest on these loans would also be borrowed. Eventually the taxpayer would default on the accumulated total of his premium-plus-interest loans; the only action the company would

take would be to cancel the policy. Meanwhile, the taxpayer would count his fictitious interest payments to the company—covered by equally fictitious loans from the company—as income tax deductions. Statute amendments and court decisions have closed most of these “fictitious deduction” loopholes.

“Fractioning” of a large income can be accomplished by splitting among the various members of a family the capital which produces the income. Then each member has his own independent income upon which he makes a separate tax return. The total of income to be taxed remains the same, but each fraction of the original income is subject to only the lower-bracket rates, so that the total tax is reduced. Of course, by this method the original owner of the income-producing capital surrenders his direct control over the fractions that he gives away, though he may retain considerable indirect control through his influence over the recipients. Moreover, gift taxes now penalize substantial gift distributions. To avoid both the gift tax and loss of control over capital, the ruse of trusts was tried for a while. The taxpayer would establish a series of trusts, with life income to himself and remainders to the members of his family, perhaps with a revocation clause so that he could subsequently reassume full control, perhaps with himself as trustee for the trusts so that he could continue to exercise control. The courts have ruthlessly gone behind these trusts, examined their intent, and disallowed them when their purpose was primarily tax avoidance.

There will never be an end to attempts at income tax avoidance, particularly with the high rates of the federal tax now in effect. But these attempts can be exposed by an administration which makes the effort to go behind the face of tax returns and discover any such legal dodges. And they can be frustrated by courts that construe the tax law according to its intent, as our present judiciary is doing, and by occasional modifications of the statute to close loopholes that judicial construction cannot plug.

Publicity of returns

With the federal income tax in existence, the states can save labor for themselves and for their taxpayers in the administration of their

own income taxes. Most states have made the basis of their taxes correspond with that of the federal tax, and their returns are modeled on the federal returns. Of course, exact correspondence is impossible, because the states do not tax income from federal instrumentalities and the federal tax does not extend to state instrumentality income, and because most state income taxes involve the taxation of nonresidents. These differences between state income taxes and the federal tax, however, have been reduced to small modificatory calculations which do not disturb the essential correspondence between the two sets of taxes. Returns for the federal income tax, accordingly, provide an excellent check on the returns submitted for the state income taxes. The federal tax law permits state tax officials to examine the federal tax returns. Some, but not all, state tax administrations are taking advantage of this permission, with gratifying results. Most of the states allow inspection of each other's returns on a reciprocal basis.

In 1924 radical elements in Congress succeeded in enacting a provision permitting publication of the names of federal income taxpayers and the amounts of their taxes. General public opposition was immediate, and a 1926 amendment limited publicity to the names and addresses of taxpayers, an arrangement discontinued two years later. Again in 1934 a publicity clause—the ill-famed “pink slip” proposal—was included in the income tax law, but it was repealed in the following year before it became effective. These publicity provisions were enacted on the theory that open announcement of taxable incomes or of tax payments would lead to discovery of evasion. In practice no such beneficial effect resulted from the 1924 clause. Instead, busybodies were given the opportunity to pry into their neighbors' personal affairs, and taxpayer resentment was fanned.

THEORETICAL CONSIDERATIONS ON PERSONAL INCOME TAXATION

A general personal income tax cannot be shifted. The argument behind this conclusion was given in full in an earlier chapter.¹⁹

¹⁹ See pp. 252 ff. of this volume

Nor can a special income tax, such as those found in New Hampshire, Ohio, and Tennessee, be easily shifted. But a special income tax can be capitalized, since subsequent purchasers of investments whose yield is taxed can turn to untaxed investments, if the prices of the taxed items are not reduced to allow for the tax.

Some nineteenth-century fiscal writers defended or advocated personal income taxes on "benefit" doctrines, arguing that individual benefit from governmental activities is in proportion to the income enjoyed under government protection. In modern times the "benefit" doctrine is rarely mentioned in connection with income taxation, since "ability" theories give a much stronger justification. If, it is argued, "taxpaying ability" is best measured by the net income of each individual, what tax could be more just than a personal income tax?

Personal income taxes with high exemptions, such as those levied in the United States, are markedly "class" taxes. From two to four million people pay a federal income tax each year, indicating that over ninety per cent of the gainfully employed are not reached by the tax. Progressive rate schedules further emphasize the class character of both federal and state income taxes. A personal income tax is one of the few impositions falling heavily on the rich and passing over the poor. Since so many other American taxes, particularly state and local levies, impose regressive burdens, the progressive personal income tax in this country has frequently been defended or advocated as a valuable fiscal counterweight. For some conservative economists, the "class" character of the income tax is self-condemnatory. But to other students of the tax problem this consideration is a matter for approval.

EMPLOYEE PAYROLL TAXES ²⁰

To provide revenue for the old-age pension plan included in the Social Security Act of 1935, the Act provided for two "payroll" taxes, one to be paid by employees eligible for such pensions,²¹ and the

²⁰ See Ralph T. Compton, *The Social Security Payroll Taxes* (Commerce Clearing House, Chicago, 1940).

²¹ Excluded were agricultural workers, domestic help, employees of common carriers, and government employees.

other to be paid by their employers. For 1937 through 1942, the rate of each tax was set at one per cent of all salaries and wages up to a \$3000 maximum. In 1942 the rate will be increased to two per cent; at three-year intervals thereafter successive one-half per cent increases will be made until the three per cent maximum is reached in 1949. Employers act as collectors of the tax on their employees, deducting the amounts involved from wage and salary payments. A 1937 statute established an old-age pension system for the employees of common carriers, financed by employee and employer payroll taxes that started at $2\frac{3}{4}$ per cent and will eventually rise to $3\frac{3}{4}$ per cent.

Six states also levy employee payroll taxes to help finance their unemployment insurance programs. In four cases the rate is one per cent; Louisiana has a one-half per cent rate, and in Rhode Island the rate is $1\frac{1}{2}$ per cent.

Employee payroll taxes allow none of the reductions employed by the personal income tax to derive net income from gross income, and there is no minimum exemption. It could be argued that in the case of wages and salaries under the \$3000 level, gross income *is* net income; there are no costs or expenses associated with the earning of such compensation. None the less, the net availability of salaries and wages to their recipients can be reduced by such elements as payment of interest on debts and bad debt losses, to which the payroll tax gives no consideration. The best view is that the employee payroll tax is a *gross* income tax rather than one on *net* income.

During the preliminary discussions of the Social Security Act, some opponents of the measure insisted that labor would demand higher wages to cover payroll tax payments, so that the entire burden of the levy would be shifted to employers, and by them would be embodied in prices and so shifted on to the consumers. There is no evidence that this fear has been realized. The tax burden imposed by the old-age pension provision was divided between two payroll taxes—the one on employees and the other on their employers. Labor apparently accepted this as a fair arrangement, and put forward no claims for reimbursement by wage increases. Wage standards in America are sufficiently above minimum-of-subsistence levels, so

that for practically all classes of employees there was an income margin out of which these tax payments could be made.

Consequences of the employee payroll tax for our national economy are interesting to analyze. Old-age benefit payments for 1941 amounted to only \$64,000,000 while the employee payroll tax receipts approached \$350,000,000. For so long as receipts from this tax continue to exceed benefit payments the tax will be in part a net revenue levy for the federal government. True, the federal government appropriates to the old-age and survivors insurance trust fund an annual amount approximately equal to the combined employee and employer payroll taxes, but the excess of this appropriation over benefit payments is invested in federal securities, and this saves the federal government from having to borrow a corresponding amount from outside sources. To the extent and for so long as the employee payroll tax operates as a net tax, it tends to reduce national consumption expenditure.²² In a recession period this tendency may be a deterrent to recovery, offsetting the creation of purchasing power by government expenditure; during the defense emergency, when reduction of civilian consumption purchasing is a desideratum, this effect of the payroll tax is a fortunate one. When the time comes that old-age benefit payments exceed employee payroll tax receipts, the effects noted above will be reversed.

²² A qualification may have to be made to this generalization if subsequent study indicates that the Social Security Act has induced low income groups to reduce "rainy-day" saving and life insurance

to death taxes. At his urging Congress voted an inheritance tax applying to transfers of personal property only. Tax rates were graduated according to the relationship between beneficiary and decedent, they were proportional to the amount of the share. Subsequently the tax was extended to transfers of real property, and the rates were increased. In 1870 the tax was repealed.

A 2 per cent inheritance tax included as an element of the federal Income Tax Act of 1894 failed when the courts held that law unconstitutional.²

In 1898, as part of its Spanish War tax program, Congress passed a death tax that was a curious cross between an estate tax and an inheritance tax. Not only was the tax rate progressive relative to the size of the decedent's total estate, but it was also graduated according to the relationship of the beneficiaries and heirs to the decedent. When the court subsequently held that the progression must be based on the shares of the individual beneficiaries and heirs, this federal death tax became an ordinary inheritance tax. It was abolished in 1902.

Another federal death tax, the first to maintain a lasting place in the federal tax system, in spite of the original view that it would be only a temporary war measure, was levied in 1916. In form it was an estate tax with an exemption of \$50,000, and a rate schedule from one to 10 per cent. Later, the tax rates were increased and the progression sharpened. In 1924, after an attempt to abolish the tax had failed, a maximum rate of 40 per cent was applied to the excess of an estate over \$10,000,000. To protect state death tax revenues, the 1924 amendment also provided that state death tax payments be credited against the federal tax up to 25 per cent of the federal tax. In 1926 the federal estate tax was again amended; the rate schedule was lowered, the maximum rate being reduced from 40 to 20 per cent, and the exemption was raised from \$50,000 to \$100,000. Credit for state death tax payments was at the same time raised from 25 to 80 per cent. Depression-born necessity for additional revenues caused the estate tax exemption to be lowered to \$50,000 in 1932, and to \$40,000 in 1935. Rates were increased by the revenue acts of 1932,

² See p. 422 of this volume

1934 and 1935, and again by the "defense" revenue acts of 1940 and 1941.

Current status

The federal estate duty is not limited to the value of net estates left by decedents. In addition to transfers of property by inheritance and bequest, it covers survivorship to joint estates³ and community property,⁴ vesting of certain trusts—revocable trusts and those to

TABLE 26
FEDERAL ESTATE TAX RATE SCHEDULE,
REVENUE ACT OF 1941

| Net Estate | Top Bracket Rate % | Total Tax | Maximum Credit for State Taxes | Net Estate | Top Bracket Rate % | Total Tax | Maximum Credit for State Taxes |
|------------|--------------------|-----------|--------------------------------|--------------|--------------------|------------|--------------------------------|
| \$ 40,000 | | | | \$ 1,290,000 | 39 | \$ 423,200 | \$ 50,960 |
| 45,000 | 3 | \$ 150 | | 1,540,000 | 42 | 528,200 | 66,960 |
| 50,000 | 7 | 500 | | 2,040,000 | 45 | 753,200 | 102,480 |
| 60,000 | 11 | 1,600 | | 2,540,000 | 49 | 998,200 | 142,000 |
| 70,000 | 14 | 3,000 | | 3,040,000 | 53 | 1,263,200 | 167,920 |
| 80,000 | 18 | 4,800 | | 3,540,000 | 56 | 1,543,200 | 233,040 |
| 90,000 | 22 | 7,000 | | 4,040,000 | 59 | 1,838,200 | 284,560 |
| 100,000 | 25 | 9,500 | | 5,040,000 | 63 | 2,468,200 | 396,080 |
| 140,000 | 28 | 20,700 | \$ 320 | 6,040,000 | 67 | 3,138,200 | 515,600 |
| 290,000 | 30 | 65,700 | 3,760 | 7,040,000 | 70 | 3,838,200 | 643,120 |
| 540,000 | 32 | 145,700 | 11,600 | 8,040,000 | 73 | 4,568,200 | 837,640 |
| 790,000 | 35 | 233,200 | 22,120 | 10,040,000 | 76 | 6,088,200 | 1,073,680 |
| 1,040,000 | 37 | 325,700 | 35,440 | over | 77 | + | + |

cover personal or economic obligations—previously made by the deceased,⁵ gifts *causa mortis*⁶ and in anticipation of death, all transfers

³ An estate in joint tenancy is an estate owned jointly by several individuals, each of whom has full rights to the entire estate, provided he does not exclude the other joint tenants against their will. On the death of one joint tenant, his rights in the estate pass to the other joint tenants by survivorship, consequently a joint tenant cannot bequeath his share in a joint estate, nor does it pass to his heirs. The most common form of estates in joint tenancy in the United States is the joint bank account.

⁴ In California and several other western states, all property acquired by a husband or wife after marriage becomes a joint estate known as "community property."

⁵ A revocable trust is one in which the trustor has reserved the power of canceling the trust entirely, or altering its terms prior to the vesting of the remainder interest. Examples of trusts for the trustor's benefit would be one in which the income was paid to a wife or legal dependent, or one whose income was used to defray some normal personal expenses of the trustor.

⁶ A gift *causa mortis* is one made by a dying person. Its distinguishing feature is that it is revocable if the giver recovers.

to take effect at death, and life insurance payable to the estate or in excess of \$40,000 to named beneficiaries. Bequests to governmental bodies, or to religious, educational, or charitable organizations, are not included in the taxable estate.

All estates exceeding \$40,000 come under the federal estate tax. The schedule of rates established by the 1941 law is shown in Table 26. State death tax credits, as established in 1926, have remained unchanged since that year.

STATE DEATH TAXES

State death taxes have a history reaching back to colonial times. Until the twentieth century, however, their significance was social rather than fiscal—the revenue they produced was trifling.

History ⁷

As early as 1687, the colony of Virginia provided that its governor should collect in fee a cask of two hundred pounds of tobacco for impressing probates and letters testamentary and administrative with the public seal, without which they were invalid. In 1825, Pennsylvania levied the first true state death tax, at 2½ per cent collateral inheritance tax.⁸ Eleven other states enacted death taxes prior to 1885. Six of these early taxes were probate duties or fees—in effect, nonproportional estate taxes—and the other six were collateral inheritance taxes. None had progressive rates or provided for graduation according to the relationship of the beneficiaries or heirs to the decedent. Within a few years of their enactment, most of these taxes were either abolished by legislative action or declared unconstitutional by the courts. None were effectively administered, and without exception they failed as revenue producers.

New York's inheritance tax law of 1885 inaugurated a new era in state death taxation. It provided a 5 per cent rate on real and personal property passing to collateral beneficiaries and heirs, and applied to such property of nonresident decedents as was located within

⁷ See William J. Shultz, *The Taxation of Inheritance* (Houghton Mifflin Co., Boston, 1926).

⁸ A collateral inheritance tax is one exempting the surviving spouse, the parents, and the descendants of the decedent.

New York. Its administrative provisions were carefully drawn, and it became a model for many other states.

In rapid succession, other states provided for the taxation of inheritance—twenty new death tax laws were enacted between 1885 and 1900. During this period, the inheritance tax was extended to beneficiaries and heirs in the direct line, and provision was made for rate progression. During this period also, the courts experienced a reversal of sentiment and found constitutional justification for state death taxes.

A new line of development in state death taxation was initiated by the North Carolina inheritance tax of 1901 and the Wisconsin inheritance tax of 1903. Both taxes grouped beneficiaries and heirs in five classes, with a separate schedule of rates for each class. Both provided five brackets of progressive rates, the progression being sharper in the North Carolina tax, which applied only to transfers of personal property. Until 1916, the states tended to model their inheritance tax laws on the Wisconsin tax of 1903. Progressive rates and rates graduated according to the relationship of the beneficiaries and heirs to the decedent became frequent. Administrative provisions were perfected, and the inheritance tax became a fruitful source of state revenue.

Utah had levied an estate tax with a proportional rate in 1905, but for a decade it remained practically unnoticed by students of taxation and by legislators in other states. In 1916, Rhode Island enacted a combination of inheritance and estate tax. In the inheritance tax the rates were graduated, like those in a number of other states, according to the relationship of the beneficiary to the decedent, and rate progression was determined by the amount of the individual share. Superimposed upon this inheritance tax was a one-half per cent estate tax, based upon the entire value of the decedent's estate before distribution. Rhode Island's system of death taxation was viewed with interest throughout the country. Two years later, in 1918, Mississippi copied the Rhode Island death tax law almost verbatim. Oregon adopted a similar death tax in 1919.

State estate taxes were further encouraged by the 1924 federal estate tax providing for a credit, up to 25 per cent of the federal tax,

on payments of state death taxes. Under this credit arrangement, if a state levied no death tax, the federal government collected the full amount of its tax. If state death taxes on an estate exactly equaled one-quarter of the federal tax, the federal government collected three-quarters of its tax. If state death taxes amounted to more than one-fourth of the federal tax, the federal government still collected three-quarters of its tax, and the estate had to pay the extra amount imposed by the state levies. Thus it was to the interest of the states to adjust their death taxes so that their rate schedules would be just one-quarter of the rate schedule of the federal estate tax. New York was the first to take full advantage of the federal credit clause. In 1925 that state enacted an estate tax supplementary to its inheritance tax, so worded that it was levied only to the extent of the difference between the New York inheritance tax and the 25 per cent credit on the federal estate tax. When the credit on the federal tax was raised in 1926, New York amended its supplementary estate tax accordingly. Other states shortly followed in adopting supplementary estate taxes designed to take full advantage of the federal credit. New York and several other states later abandoned inheritance taxation altogether, and changed to estate taxes modeled on the federal law and with rate schedules based on the federal credit.

Current status

Every state except Nevada levies either an inheritance tax, an estate tax, or a combination of the two. State death tax yield during the past decade has varied between \$133,000,000 and \$181,000,000, according to business cycle developments and the chance grouping of the deaths of wealthy men.

For constitutional reasons,⁹ these state death taxes cannot apply to real property or tangible personalty owned by resident decedents but located outside the taxing state; such "outside" property is subjected to the nonresident death taxes of the states wherein it is located. In general, the rules for calculating the net taxable estate are similar to those for the federal estate tax, but the treatment of gifts made in contemplation of death, charitable bequests, insurance, and

⁹ See p 216 of this volume.

some other items varies somewhat. Absence of uniformity is particularly noticeable in the taxation of the property of nonresident decedents.

Ten states accomplish death taxation exclusively through estate taxes. Minimum exemptions under these estate taxes range from \$10,000 in Oregon and Utah to \$100,000 in Alabama, Arizona, Florida, and Georgia, whose estate duties are merely enactments of the federal estate tax credit. Utah's estate tax has the lowest rate schedule—3 per cent on the first \$25,000 of an estate, rising to 10 per cent on the excess over \$125,000. At the other extreme, North Dakota's estate tax has a schedule rising to 23 per cent on estates over \$1,500,000.

Rate schedules vary even more widely among the thirty-eight state inheritance taxes. To begin with, all of these inheritance taxes involve minimum exemptions and rate graduation according to the relationship of the beneficiary or heir to the deceased. Minimum exemptions range from \$75,000 for widows in Kansas, to \$100 or none at all in many states for distantly related beneficiaries. New Hampshire still clings to a collateral inheritance tax—no tax whatsoever on transfers to direct heirs, and 8½ per cent on transfers to other beneficiaries and heirs. A few states have only two rate schedules—one for direct inheritors, and the other for collaterals. Inheritance taxes of other states differentiate three, four, and even five relationships.

Superimposed on this relationship discrimination, in all but four states, is a rate progression based on the size of the beneficiary's share of the estate. The progression may be mild, as in Maine, where the top rate on the shares of direct heirs is 3 per cent and those of collateral heirs, 6 per cent. Or it may be sharp, as in Minnesota, where direct heirs pay up to 12 per cent, and distantly related beneficiaries up to 60 per cent.

Finally, as a supplement to the regular inheritance or estate tax, most states impose a duty to cover the full allowance of the federal credit. In all cases, the rate schedule of this supplementary tax is graduated from three-quarters per cent on the first \$50,000 in excess of \$100,000 to 16 per cent on the excess over \$10,000,000. If regular

inheritance or estate tax payments exceed the amount of the supplementary estate tax, nothing is paid under the latter. But if the amount of the supplementary tax is greater, the difference is collected by the state. No additional burden is imposed on the taxed estate, since its federal tax payment is reduced accordingly.

JURISDICTIONAL CONSIDERATIONS

During the early 1920's, an estate, or portions of it, might be subjected to overlapping taxation by two, three, or even more states. Tangible personalty would be claimed for taxation by the state of the deceased's domicile and by the state wherein the property was located. Corporation shares might be taxed by the state of domicile, the state where the certificates were physically located, and the state or states of the company's incorporation—with Wisconsin claiming at one time the right to tax a nonresident estate if it owned shares of non-Wisconsin corporations possessing property located in Wisconsin. Other intangible items could also give rise to multiple taxation.

A few states met the issue by limiting the base of their death taxes to property owned by resident decedents. Urged by the National Tax Association, a much larger number provided for reciprocal exemption of the intangible property of nonresident decedents. Under a reciprocal clause, a state levied no death tax on the intangible property of decedents domiciled in those states which did not tax the intangible property of decedents resident in the taxing state. Such was the impetus of this movement that by 1932 thirty-nine of the forty-seven death tax states had reciprocal exemption provisions. It seemed possible, even probable, that by this method of mutual accord, the states themselves would end the abuse of multiple death taxation.

Meanwhile, beginning in 1925, the United States Supreme Court pruned away various possibilities of double death taxation by defining and limiting the taxable situs of different classes of property. First a single situs—the state of location—was assigned to tangible personalty.¹⁰ The same rule was subsequently established for money

¹⁰ *Frick v. Pennsylvania*, 268 U. S. (1925) 603

in a safe deposit box.¹¹ Next to be outlawed was the Wisconsin system of taxing a nonresident decedent's holdings of the shares of foreign corporations which owned property located in the taxing state.¹² Finally, government bonds were conceded a tax situs only in the state of the decedent's domicile,¹³ and a similar restriction was laid on the taxation of the most important class of intangible personalty—shares of corporate stock¹⁴

Thus, with or against their wills, the states appear to have had their problem of double taxation settled. Although the Supreme Court has not stated the principle in universal terms, and though exceptions may be developed in the future, property generally would seem to have but one situs for death taxation—realty and tangibles where they are physically located, intangibles at the domicile of the decedent. Nonresidents remain subject to taxation under state death tax statutes only when they die possessed of realty or tangibles physically within the taxing state. On such property they are not taxed by the states of their residence—no double taxation is involved.

THE TAXABLE ESTATE¹⁵

Estate taxes apply to the *net* estate left by the deceased, inheritance taxes to the *net* shares passing to the beneficiaries. Determination of the gross estate or shares, and determination of the allowable deductions, both raise points of practical and theoretical inquiry.

Elements of the gross estate or share

All property of a deceased,¹⁶ over which the taxing government has jurisdiction, is included in the calculation of "gross estate." By

¹¹ *Blodgett v Silberman*, 277 U S (1928) 1; *Baldwin v Missouri*, 281 U S (1930) 586

¹² *Rhode Island Trust Co v Doughton*, 270 U S (1926) 65

¹³ *Farmers Loan & Trust Co v. Minnesota*, 280 U S (1930) 204

¹⁴ *First National Bank of Boston v State of Maine*, 284 U S (1932) 312

¹⁵ A sample state death tax report form showing how the jurisdictional and economic elements of an estate are to be accounted for in determining tax liability is reproduced in Appendix D, p 822 of this volume. No special report form is used for the federal estate tax.

¹⁶ In the eight states where the system of community property obtains, only one-half of the joint property of husband and wife is deemed to belong to the estate of the first to die.

a fortunate quirk of judicial reasoning, the "federal instrumentalities" limitation has never been applied to state death taxation, nor the "state instrumentalities" limitation to federal death taxation. So-called "tax-exempt" bonds, therefore, must be fully listed for both state and federal taxation.

Gifts of property before death were early utilized to avoid death taxes applying only to property of which the deceased died possessed. To meet this threat, the federal estate tax and most state death taxes have been extended to include "deathbed" gifts, and gifts made in contemplation of death. Usually the law provides that a gift made within a specified period before death, ranging from ninety days in Kansas to six years in Arizona, is presumptively made in contemplation of death and to avoid the death tax. The law cannot go further than to establish a presumption of intent to avoid the tax,¹⁷ and such presumption may, of course, be rebutted by evidence to the contrary. In suits on this issue the taxing government is usually at great disadvantage; the federal government wins less than 5 per cent of its "contemplation" cases, the states even less.

Another "outside" item which the tax laws insist must be included in the gross estate is the *corpus* of trusts created by the decedent during his lifetime to avoid death taxation. No constitutional problem is involved in extending death tax laws to cover such trusts, but the courts construe "trust tax" clauses very strictly, and if the statute is not to fail of its purpose, its wording must be both comprehensive and precise. The federal estate tax is specifically extended to trusts of which the maker was a beneficiary during his lifetime or over which he maintained any power of revocation or control. Some states have adopted the language of the federal law, but in many cases their "trust tax" clauses have been faultily drawn and accord little protection against this form of avoidance.

¹⁷ *Schlesinger v Wisconsin*, 270 U S (1926) 230; *Heiner v. Donnan*, 285 U S (1932) 312. A good survey of the development of law on the subject is presented in C Lowell Harris, "Gifts in Contemplation of Death," *Taxes*, March 1941, pp. 151-160 and April 1941, pp. 216-221.

Deductions

Debts owed by the deceased are deducted from his assets to determine the net estate. An inheritance tax, based on the share passing to each beneficiary or heir, necessarily excludes the costs of administering the estate, since these costs are subtracted before the estate is divided. Administrative expenses are also allowed as a deduction under the federal estate tax, but some state estate taxes include them on the theory that the tax is imposed on the net estate existing at the moment of the owner's death, and administration costs develop after the owner's death. The federal tax does not allow deduction of state death taxes in the calculation of net estate, but more than half the states allow full deduction of the federal tax.

Bequests to governmental bodies or to private educational, charitable, or religious organizations are generally allowed as deductions. Most states, however, limit the deduction to bequests made to institutions within their own borders; only ten states generously exempt all such bequests, irrespective of the location of the beneficiary.

To prevent rapid repetition of death taxes when heirs die soon after their legators, the federal government and fourteen states provide that within a specified period no second death tax shall be levied upon any part of a decedent's estate earlier subjected to a death or gift tax. In the phraseology of the tax statutes, such part of an estate as was subjected to a prior death or gift tax within the specified period is allowed as a deduction from the gross estate. Under the federal law the period is five years. State laws set periods ranging from one to six years, five being the most common. Several states limit this deduction to property passing to direct heirs.

Time of appraisal

Were property and investment values always stable, it would not matter when the assets of an estate were appraised for death taxation. Value as of the date of the owner's death, value as received by the executor or administrator in the course of liquidating the estate, or value as transmitted to the beneficiaries and heirs—all would be identical. But with property and investment values rising

or falling rapidly, these three values may differ widely. Which value is chosen as basis for death taxation may be of considerable importance to the taxing government and to the heirs and beneficiaries.

Legal theory assumes that an estate passes from its former owner to its new owners at the moment of the former's death. An administrator or executor is only a special trustee for the heirs and beneficiaries, and before ever he enters upon his duties, the transfer of title has already occurred constructively. In strict theory, therefore, the taxable value of an estate and of the distributive shares is determined as of the date of the owner's death. In actual administrative practice, other values are utilized—for items whose prices are quoted in active organized markets, value as of the time when the executor or administrator entered upon his office is accepted; for other items, the prices actually received upon conversion are accepted. In 1935, the federal estate tax was liberalized to permit the executor or administrator to establish the tax valuation of the estate as of one year after the decedent's death.

PERSONAL EXEMPTIONS AND RATES

Major issues in death taxation, as in the personal income tax, are the amount of minimum exemptions to be allowed, and the degree of progression to be applied to rate schedules. In addition, fascinating theoretical questions are raised by relationship discrimination in state inheritance taxes.

Minimum exemptions¹⁸

Minimum exemptions in state inheritance taxes are true personal exemptions—each beneficiary and heir enjoys his particular exemption, its size usually determined by his relationship to the deceased. Generous allowances to the surviving spouse and to the direct heirs find ample justification. Frequently such heirs were dependent upon the decedent for their support, and have now lost a provider. Frequently also, in the case of widows and minor children, their

¹⁸ See William J. Shultz, "Death Tax Exemptions," in Tax Policy League, *Tax Exemptions* (the League, New York, 1939), Ch. IX.

shares of the estate are thereafter their sole means of support. When such shares are small, to tax them would work real hardship upon the recipients.

But there is no justification for exemptions to other classes of beneficiaries. A brother, or a nephew, or a cousin rarely suffers diminution of financial capacity by the decedent's death. Their shares of the estate are pure windfalls. Even on administrative grounds there is no argument for exemptions to collateral beneficiaries. If the total estate is large enough to be reported to the tax administration, the executor's or administrator's tax report is audited as a unit, and the exemption of a \$100 or \$200 bequest to some distant relative does not save the administration any labor.

Under an estate tax, a minimum exemption does not operate as a personal exemption—it does not benefit any predetermined class of individuals. As most wills are drawn, death taxes reduce the amount of the residuary estate after all specific legacies are paid. Hence a minimum exemption under an estate tax benefits the residual heir or legatee, whoever he may be. In most wills the residual estate passes to the widow and children of the decedent, in which case they benefit from the minimum exemption. But this is not an invariable rule. Where direct heirs are covered by a specific trust, and a small residuary estate is left to some special interest of the legator, the exemption favors this interest, whatever or whoever it may be.¹⁹

With the personal effect of estate tax exemptions so uncertain, administrative and fiscal considerations must be given predominant weight in setting their size. Primary intent of the exemption is to save the tax administration the costs of checking and auditing thousands of returns on small estates the tax receipts on which would not cover, or would do little more than cover, the costs involved. The \$10,000 exemption allowed under the estate taxes of Oregon, Rhode Island, and Utah probably comes as close to fulfilling this purpose as any other arbitrarily chosen figure. Minimum

¹⁹ An exception must be made in the case of the New York estate tax. No exemption is allowed to the general estate but specific personal exemptions are allowed on the shares passing to direct heirs.

exemptions of \$100,000, allowed in Alabama, Arizona, Florida and Georgia, are not dictated by ordinary administrative or fiscal considerations; these estate taxes are purely "parasitic" levies imposed to take advantage of the federal estate tax credit, and the \$100,000 exemption is dictated by the federal credit.

The large exemption of the federal estate tax has a special reason. On the occasion of the first federal estate levy in 1916, Congress determined that the federal government would limit its death taxation to large estates, and leave to the states the field of small estates. In effect, the federal estate duty was to be a sort of surtax superimposed over and above the relatively moderate state taxes. Incidentally, since only a relatively small number of estates would come under its ken each year, the federal tax administration would save itself enormous administrative costs. That original intention has been maintained. The original \$50,000 exemption was raised to \$100,000 in 1926 when revenue needs were eased. Despite the frantic search for additional federal revenue in recent years, the estate tax exemption was lowered only to \$40,000.

Relationship discrimination in inheritance tax rate schedules

As in minimum exemptions, a fairly convincing argument can be presented for lower taxes on the shares of an estate going to a widow, and to children, parents, and other direct dependents of the deceased than on the shares passing to other beneficiaries. Direct heirs come into possession of a certain wealth, but since they lose their provider at the same time, their inheritance is far from pure gain. To justify lower rates on nephews than on cousins, on first cousins than on second cousins, on blood relatives than on relatives by marriage, is more difficult. French and Italian writers have argued at length that grief for the deceased varies in intensity with the closeness of the blood tie and that lower rates on nearer collateral relatives compensate for these varying degrees of grief. Also, they insist, inheritance tax rate discrimination according to the relationship of the beneficiaries and heirs to the deceased helps preserve a proper balance in the monetary side of the family edifice. Such reasoning is alien to American modes of thought.

Complicated relationship classifications such as are still found in a few state inheritance taxes are hangovers from European traditions which once influenced our inheritance tax legislation. Current tendencies are towards differentiating at most between direct heirs and other beneficiaries and, even further, towards replacing inheritance taxes by estate duties having no relationship discrimination.

Progressive rate schedules

Progressive rate schedules in death taxes are difficult to justify under current distributive doctrines. Obviously the burden imposed by a progressive estate tax can bear no relation to the "abilities" or "benefits" of various heirs and beneficiaries who receive different-sized bequests either by the testator's will or the laws of descent and distribution. Just as obviously, "ability" and "benefit" can have no significance as applied to the deceased owner of the estate. "Ability" and "benefit" doctrines can be dragged into the controversy over progressive estate taxes only by interpreting an estate tax as a "back tax" on the owner of the estate.

Progressive inheritance taxes fare little better. Relative taxpaying ability of the beneficiaries and heirs cannot be determined by exclusive reference to the shares they received from the estate of a decedent. In the first place, wealth alone is not a satisfactory measure of taxpaying ability. Moreover, the share of an estate received by a beneficiary or an heir rarely constitutes his entire wealth, so that rate progression based solely on the size of his share cannot by any theory approximate his taxpaying ability. Surely a millionaire who receives a one-thousand-dollar bequest has a relatively greater taxpaying ability than a pauper who receives a fifty thousand dollar bequest. Yet under a progressive inheritance tax the latter is taxed more heavily than the former.²⁰

In spite of the fallacies involved, glib "ability" and "benefit" justifications for progressive death tax rates are given and popularly accepted. The true motivation for this progression, however, would

²⁰ The German inheritance tax of 1919 provided that the prior wealth of the heir or beneficiary should be taken into account in determining the application of a progressive rate schedule. The provision failed because the administration proved impossible.

appear to be not theories of tax justice but the social intent to equalize distribution of wealth and check hereditary transmission of large aggregates of property.

Possibilities of progression in state death taxes are sharply limited. Let any one state or group of states carry rates on large estates or inheritances above the general level, and wealthy individuals, to protect their estates, will transfer their residences to lower-taxing states. At the present time the federal estate tax credit allowance—three-quarters per cent to 16 per cent—more or less establishes the maximum for state death tax progression. But the federal government is not bound by such considerations, since even confiscatory death tax rates are not likely to cause a man to move to another country. Evasion in death taxation is rare, because the tax is calculated and paid by executors and administrators who are officers of the courts, and not by owners of estates. Nor is avoidance possible by investment in tax-exempt securities; no form of property is constitutionally exempt under death taxation. Avoidance by the making of gifts during the estate-owner's lifetime has been plugged by the enactment of federal and state gift taxes. And the statutes and courts have generally blocked avoidance by creation of trusts and other circumventions. Congressional discretion is the only limit to progression in the federal estate tax.

Where the rate progressions are identical, a progressive estate tax imposes a heavier burden than an inheritance tax. If an estate is divided into many shares, each share is a reduced unit and comes only under the lower bracket rates of an inheritance tax. But if an estate tax applies, there can be no division of the estate to bring the shares under the lower bracket rates. The total estate determines the amount of the tax, without regard to the division into beneficiaries' shares.

The federal estate tax credit for state death taxes

Bitter controversy has been provoked by the federal estate tax provision that state death tax payments may be credited, up to a prescribed fraction, against federal estate tax payments, as indicated

in Table 26.²¹ This clause has been and is still denounced in some quarters as coercing the states to maintain uniformity of rate burden in state death taxation. It has been criticized as opposed to the basic principles of American government, as impairing the freedom of the states in the exercise of their home rule, and as subordinating to the domination of the federal government the right of the states to regulate their own affairs.

Two arguments have been advanced in support of the credit. First, the credit softens the burden of the federal estate tax and permits the states to levy correspondingly heavier death taxes. A similar result could be obtained more simply, however, by an outright reduction of the federal estate tax rates. The second argument for the credit clause is more potent. Prior to the enactment of this clause in 1924, the states had shown a tendency to bid for the residence of wealthy individuals by competitive reduction of death tax rates. Florida carried this competition to the point of adopting a constitutional amendment forbidding the enactment of a death tax, and subsequently advertised this constitutional provision as a lure for rich residents.²² Without some check, the competition might have forced states desiring and needing death tax revenues to surrender this form of taxation. Within the limits of the credit allowed, all death tax competition among the states has been ended. Whether a rich decedent was domiciled in Nevada or Massachusetts, his estate pays the same tax; if he was a resident in Nevada, the federal government collects all the tax, if he was a resident in Massachusetts, the state government takes part of the tax and the federal government part.

Coercion of the states is, of course, the very essence of the credit clause. A minority of the states is being forcibly restrained from "hijacking" the death tax revenues of the majority. Such coercion is, perhaps, not altogether a matter for condemnation. The practical

²¹ See pp 469 and 759 of this volume. The present credit allowance starts with $\frac{3}{4}$ per cent on the first \$50,000 of the estate in excess of \$100,000, and rises to 16 per cent on the excess of the estate over \$10,100,000.

²² An amendment to the Florida constitution permitting the levy of a death tax to take advantage of the credit clause was ratified in 1930.

effect of the clause was to double the state death tax revenues between 1926 and 1931.

Tax rates on property of nonresident decedents

How to bring the death tax burden on the property of nonresident decedents into harmony with the burden on estates of resident decedents is a problem still bothering many states. Real and tangible property physically located within the taxing state is likely to be a small fraction of the total estate of a wealthy nonresident decedent. To subject it directly to a progressive inheritance or estate tax runs counter to the principle that such a tax should take into account the entire estate of a decedent or the entire amount of a beneficiary's share. A special flat-rate tax on the taxable property of nonresident decedents—the so-called “Matthews flat-rate plan”—is one solution of the difficulty. By sacrificing the progressive principle, it avoids improper discriminations between nonresident decedents. It is also subject to the limitation that the rate on any nonresident decedent's property must never exceed the rate which would have been charged had the decedent been domiciled in the taxing state.²³ An alternative solution is the application of the same progressive rates to nonresidents' and residents' property with the rates determined by the total estate or share rather than the amount of property actually within the taxing state. This so-called “New Jersey ratio plan” received the approval of the United States Supreme Court some two decades ago,²⁴ and the approval still stands.

To some extent the same discrimination is involved in the application of progressive death taxes to the property of resident decedents. The state of the decedent's domicile cannot tax real property and tangible personalty belonging to the decedent's estate but located in other states. Therefore the final rate actually applied to the property of a resident decedent may be determined by a fraction, instead of the entirety, of the estate or shares. This shortcoming could be remedied by extending the “New Jersey ratio plan” to the taxation

²³ See *Smith v Loughman*, 245 N. Y. (1927) 486.

²⁴ *Maxwell v Bugbee*, 250 U. S. (1919) 525.

of the estates of resident decedents. Since the courts have approved its application to nonresident estates, it is difficult to see why they should not sustain its application to resident estates.

ADMINISTRATION

Administration of death taxes enjoys an advantage not present with any other tax. Assessment and payment are focused on the executors and administrators of the taxed estates. As officers of the probate courts, these individuals act in quasi-official capacity. Their acts are under constant judicial surveillance. They dare not attempt evasion of the state and federal death taxes. Moreover, the executor or administrator does not actually appraise the estate. In some states this function is performed by "appraisers" appointed by the probate courts, and the appraisal made for the purpose of distributing the estate is available to determine its tax liability. In other states appraisal is made by representatives of the state tax commission or other agency administering the death tax, and may be used for distributing the estate.

Audit of death tax returns for evasion or error is hardly necessary. But the tax administration must often pursue far-reaching inquiries into the background of large estates. Lifetime transactions of the deceased must be examined to determine whether any of them constitute attempts at death tax avoidance. When this function is laxly handled, a death tax is doomed to partial failure. The federal Estate Tax Division has been particularly effective in this field.

Many states have given scant thought to the administration of their death taxes. In several the tax is still administered by the probate courts although they are utterly unequipped for the task. Elsewhere state death tax collection is an incidental function attached to the office of the State Treasurer, the State Comptroller, or the State Auditor—also an unfortunate arrangement. More than half the states, however, have wisely delegated their death tax administration to state tax commissions or other central tax agencies.

Existence of the federal estate duty has facilitated the work of the state tax administrations on large estates. State tax departments

have available the careful investigations of the federal Estate Tax Unit as a check on their own audits. In a number of states, apparently, the tax authorities have shifted to the federal examiners the entire responsibility for checking returns on large estates, and are content to accept whatever returns are finally satisfactory to the federal people.

THEORETICAL CONSIDERATIONS

Because of the high rates embodied in death tax schedules, the severity of tax payments on large estates, and the social issues involved, the principles of death taxation have been the subject of much controversy. A voluminous literature on the subject exists

Economics of death taxes

The question of who bears the burden of death taxes does not depend, as in the case of most other taxes, on economic reasoning but upon categorical assumptions about the nature of the tax. Four mutually contradictory views have been advanced.²⁵ The first, attributed to the English philosopher-economist Jeremy Bentham, is that death taxes impose no burden upon anyone, since the deceased accumulator of an estate is inanimate by the time the tax is imposed, and his successors have only a legal expectation without any economic basis. The second, expressed by the English economist Arthur Pigou and recently emphasized by the American writer James Hall, is that a death tax is a "back" property or income tax, so that its incidence is the same as these other taxes on the deceased; somewhat related is the view of Professor Shyras that the deceased had to forego consumption to anticipate the tax on his estate, so that it operates as a "back" consumption tax, and has the incidence of such a tax. The third and most common view is that the incidence of a death tax is on the beneficiaries, since they are deprived, in a negative way, of wealth which they would otherwise by operation of law or bequest have received. Finally, a few writers argue that the burden of the tax is divided between the deceased and his bene-

²⁵ James K. Hall, "Incidence of Death Duties," *American Economic Review*, Vol. XXX, March 1940, pp. 46-59.

ficiaries, to the extent that the deceased may have been affected to some extent in accumulating his estate by anticipation of the taxes on it. There is no basis for choice between these four propositions, since all rest upon unprovable assertions.

Death taxes are frequently denounced as taxes on capital. It is argued that, by absorbing a portion of the capital of decedents' estates, they deplete the capital resources of the country, and thus check its economic progress. As was pointed out in an earlier chapter, no tax can destroy or absorb capital.²⁶ The true issue is the relative extent to which a tax ultimately reduces consumption expenditures or savings. Since savings comprise the current fund which finances the creation of new capital properties, if all current savings are actually being utilized for capital construction, a tax which tends to reduce savings may retard the capital growth of the country. Every tax is likely to impinge on savings to some extent, but death taxes, as we shall see, are paid practically in entirety out of potential savings. Hence, relative to the amount of tax collected, they reduce national savings more than most other taxes.

Unless there is sufficient insurance to cover the death taxes on an estate, part of it must be sold to raise cash for the taxes. Eventually, these items from the taxed estate are purchased by individuals who, except for such purchase, would have placed their current savings in other investment. Indirectly, the savings of these individuals have been diverted to governmental use. Were heirs and beneficiaries subsequently to stint themselves and save the amount of death tax on their shares, such saving would offset the diversion of the savings of the purchasers mentioned above. But no such offset occurs, since heirs and beneficiaries look upon the net amounts they receive as windfalls, unrelated to the normal currents of their income and expenditure, and do no extra saving.

There is a remote possibility that the decedent prepared, by personal abstinence, for the death taxes on his estate. He may have taken out life insurance to meet the death taxes eventually to be levied on the estate, and have covered the premium payments by

²⁶ See pp 268-269 of this volume.

reducing his consumption expenditures. More likely, however, such insurance premiums were covered out of income which would otherwise have been saved and devoted to other forms of investment, so that here also savings rather than consumption expenditure are reduced.

Death taxes, then, exercise a relatively greater deterrent effect on national saving than other taxes paid, in part at least, by a reduction of consumption expenditure. Whether such reduction of savings retards capital creation depends on the margin between national savings and capital creation. The evidence we have on this subject, covering the 1920's, indicates that after reduction of savings by death taxes and all other taxes then in effect is accounted for, there remained a wide margin of oversaving. We may conclude that, for the 1920's at least, American death taxes did not retard the accumulation of national wealth.

Distributive theories

Death taxes are commonly justified under the "ability" theory. It is argued, first, that if the tax be considered as upon the decedent, it strikes him at the moment of his supreme taxpaying ability—namely, on the occasion of his death, when he has no further earthly use for his property. A second branch of the ability argument is that, if the tax be considered as upon the beneficiaries or heirs, it applies to property on which at the moment they possess high taxpaying ability. Inherited wealth is in the nature of a windfall. Beneficiaries and heirs have not earned it and have no right to it other than that created by state statutes of descent and bequest. Furthermore, until they receive their shares from the executor or administrator of the estate, the taxed property does not belong to them and they cannot be considered as burdened by any taxes upon it.

These "ability" arguments may convince those who wish to be convinced of the basic "justice" of death taxes. They collapse badly, as we saw,²⁷ when the attempt is made to use them as justification for rate progression in death taxes. Likewise, they offer but weak

²⁷ See p. 482 of this volume.

support for inheritance tax rate graduation according to the relationship of the beneficiary or heir to the decedent

A second distributive justification for death taxation—the “silent partner” doctrine—maintains that an individual can accumulate an estate only by reason of the business milieu provided by the State. In effect the State is a silent partner in the accumulation of every individual fortune. Its share in the accumulation of large fortunes is relatively greater than for small fortunes. A death tax is merely the State’s method of collecting its share in the partnership assets on the dissolution of that partnership. While the “silent partner” doctrine supports estate taxes and rate progression, it offers no justification for inheritance taxes and relationship discrimination.

During the early part of the nineteenth century, a number of economists argued that death taxes find their justification in the “benefit” theory of taxation. Sometimes the “benefit” involved was stated as the government’s protection of the estate in the period from the death of the original owner to the actual distribution of the estate among the heirs. Sometimes the concept of “benefit” was extended to include the general protection afforded the property during the lifetimes of the original owners and the heirs. Proponents of the “benefit” theory of death taxation were usually anxious to limit the tax to a moderate transfer fee, and advanced the “benefit” argument as authority for so limiting the tax.

A number of writers have argued that a death tax is a sort of lump-sum “back tax,” taking the place of property and income taxes which might have been levied during the lifetime of the decedent, or which were levied but were evaded or avoided by him. While such argument might justify an estate tax, it offers no support for an inheritance tax.

Finally we may note the contention of some legalists that there is no “natural right” of bequest or inheritance. Transfer of property at the death of the owner is a privilege accorded by the laws of the states, and what the states give, they may take away or limit to whatever extent they please. Although this is true of transfer of property at death, it is no less true of any other civil status or transaction. Bequest and inheritance are no greater “privileges” than all

the multitude of others we enjoy under civil government. Herein, therefore, there is no justification for a special tax on these transactions. Moreover, this argument provides no basis for federal death taxation, since the "privilege" of bequest and inheritance are accorded entirely by state law, with federal law making no contribution whatsoever.

That death taxes find no consistent support in the theorists' canons of distributive justice does not condemn these taxes. As was indicated in Chapter XII, these "canons" are rationalizations rather than reasons, and primarily useful for propaganda purposes. Logically or illogically, popular opinion in the United States accepts death taxes as "just," and thus gives them pragmatic sanction.

Equalization of wealth through death taxation

With increasing frequency death taxes are being justified on the ground that they reduce the inequality of wealth and check the development of a hereditary plutocracy. There can be no question but that death taxes do have these effects. And certainly this social consideration has been as important a motivation of the high progressive rates of the federal estate tax as any fiscal considerations. Whether the tax student approves or disapproves of this motivation depends upon his attitude towards "regulatory" taxation in general, and his views upon the economic advisability of wealth equalization.

A specific proposal to utilize the federal estate duty to check the transfer of family fortunes from generation to generation has occasionally received considerable favorable attention. Under this plan, the estate of every decedent would be divided into two parts—the first part would equal in value the amount of the property which the decedent inherited and received as gifts during his lifetime, the second would consist of the additional wealth he accumulated through his own efforts. Normal estate tax rates would apply only to this second part of the decedent's estate. An additional discriminatory tax would be levied on the first part. Certain features which recommend this project are lacking in other proposals to use death taxes as a means of equalizing wealth distribution. It is in harmony with the popular disapproval of the "idle rich." It cannot be

charged with discouraging individual initiative. In this respect, its effect, if any, would be to stimulate increased efforts on the part of rich men, who had inherited their fortunes, to accumulate fortunes of their own to transfer to their children at the lower schedule of rates. Its principle could be effected, without altering the death tax revenue, by simultaneously reducing the death tax rates on earned wealth while increasing the rates on unearned wealth.

GIFT TAXES²⁸

A tax might be imposed on gifts as an incidental method of producing some additional revenue, just as taxes have been or are levied on other transactions—for example, the issuance or sale of corporate securities, the payment of checks, the sale of theater tickets. Such a casual tax on gifts would be legally sound, but would have little else to recommend it. It would affront the popular sentiment that gift-giving is a meritorious act, and it would be difficult to administer.

Our current federal and state gift taxes, however, were not enacted as independent revenue measures. They were passed, and they are popularly accepted, as supplements to federal and state death taxes. Though they occasionally yield substantial revenue, this is incidental to their primary purpose of checking the avoidance of the death taxes by making *inter vivos* gifts. Incidentally they also penalize avoidance of the federal income tax by the splitting of a large income-yielding capital among the members of a family.²⁹

The federal gift tax

After long agitation, a federal gift tax was enacted in 1924. It applied when the sum total of gifts made in the course of a year exceeded \$50,000. As with the estate tax, charitable gifts were exempt. The rate schedule was progressive, from one per cent on the first taxable \$50,000 to 40 per cent on the excess over \$10,000,000. No provision was made for cumulative calculation of gifts made in

²⁸ The authoritative study on this subject is C Lowell Harriss, *Gift Taxation in the United States* (American Council on Public Affairs, Washington, 1940).

²⁹ See p. 463 of this volume

successive years. Consequently a taxpayer could minimize the total of his gift tax payment by making his gifts in instalments over a period of years. Anti-estate-tax sentiment in 1926, while it failed to accomplish the abolition of the federal estate tax, did in that year force the repeal of the gift tax.

A new gift tax, more closely attached than the first to the federal estate duty, was enacted in 1932. The rate schedule was set at exactly three-quarters that of the estate tax, on the theory that the earlier payment of the gift tax made the ultimate burden of the two taxes approximately even. When the rates of the federal estate duty were increased in 1934, 1935, 1940, and 1941, those of the gift tax were raised in correspondence. Furthermore, the tax rate is determined by the cumulation of gifts in various years. Gifts made in any year are taxed at a rate determined by the sum total of all prior gifts made by the donor since 1932, and at the same time, a back tax is imposed on the prior gifts to cover the higher rate calculated on the basis of the new, larger sum total. As a consequence of this method of calculation, a donor pays the same tax whether he makes a large gift in a single lump sum, or spreads it over a period of years.

Even with this correlation of rates, however, the gift tax does not remove all possibility of estate tax avoidance through gift-making. If the owner of a \$10,000,000 estate maintains it intact until his death, the estate tax under present rates is \$5,546,700. If he gives half of it to his son during his lifetime, the gift tax is \$1,692,525. If we follow the argument of the sponsors of the tax that from the time of making the gift to the time of the donor's death, the taxpayer loses, and the government gains, a probable one-third through interest, we may add an additional \$564,175 interest loss, making the ultimate total of the tax \$2,256,700. At the donor's death, the estate tax on the remainder of his estate will be \$2,256,700. By shifting \$5,000,000 of his property from the top bracket of the estate tax, subject to a 69 per cent rate, to a sequence of lower brackets in the gift tax, our hypothetical rich man saves \$1,033,300.

The yield of the federal gift tax during its first few years surprised even its sponsors. In 1935 it produced \$72,000,000, in 1936 \$160,000,000. These high returns were a temporary phenomenon, how-

ever, since they resulted from a rush to avoid the new high estate tax rates by gift making. Subsequently the yield of the gift tax settled to \$25,000,000 to \$35,000,000. But these figures do not represent its full productivity, since in each year many gifts which would otherwise have been made to avoid subsequent estate taxation were probably discouraged. Ultimately estate duty receipts will be greater because of the current gift tax levy.

State gift taxes³⁰

Wisconsin levied a gift tax in 1933; by 1941 eight other states had adopted the innovation. The Wisconsin tax is unusual in that it is assessed to the donee. All the other state gift taxes, like the federal levy, are assessed to the donor.

Two types of exemptions are allowed. The first is a specific exemption on the total of gifts made by the donor. In some states this is a single lump sum, in Oregon, for example, it is \$10,000. In several states, however, this donor's exemption is a graduated series of specific exemptions covering categories of donee relationships. The second type of exemption is an annual exemption per donee, which may be uniform as in California and North Carolina, or may be graduated according to the relationship of the donee to the donor, as in Colorado.

With the exception of the Oregon tax, the rates of the state gift taxes are graduated not only by amount progression but by the relationship of the donor to the beneficiary. The Minnesota tax, for example, has a rate schedule ranging from $\frac{3}{4}$ per cent to $13\frac{1}{2}$ per cent on gifts to a spouse, direct descendant or ancestor, a second higher rate schedule for gifts to a brother or sister or their children, a third for gifts to uncles, aunts, and cousins, and a fourth ranging from $3\frac{3}{4}$ per cent to 45 per cent on gifts to more distant relatives and strangers. Generally these gift tax rates are the same as the states' inheritance rates; Oregon provides the interesting case of a gift tax rate schedule higher than that of its estate tax. California, Louisiana, and Oregon have adopted the federal requirement that

³⁰ See H. Arnold Strangman, "Taxation of Gifts by the States," *Taxes*, January 1941, pp. 36-37.

gifts made in successive years must be aggregated to determine tax liability.

These state gift taxes, like the federal levy, have been adopted not so much for their direct revenue yield, as to check avoidance of the states' death taxes.

CHAPTER XX

Taxes on Business

NARROWLY used, the term "business taxes" would apply only to levies on industrial, commercial, and service enterprises, and would exclude special taxes on financial, agricultural, extractive, and public service enterprises. In many books on Public Finance, "business taxes" are given this limited connotation. We, however, will employ a wider meaning. For us, "business taxes" shall cover all levies, whatever their legal names, imposed on forms or classes of profit-seeking enterprise because of their existence in such forms. A gross income tax on railroads, a premiums tax on insurance companies, a severance tax on petroleum companies, as well as a general corporation tax, are all "business taxes," because each of these classes of enterprise is a form of "business." Excluded from the "business tax" concept will be commodity, property, and transaction taxes incidentally paid by business enterprises.

Business activity is for several reasons a favorite basis of taxation. It has the approval of the courts. Business taxes are generally indirect taxes—they are frequently shifted to the consumers of the commodities and services sold by the taxed enterprises—and governments like indirect taxes because of their administrative simplicity and because they assure a relatively constant inflow of tax revenue. Even when they cannot be shifted, business taxes are looked upon with approval, on the argument that business enterprise as such benefits specially from many governmental activities and may properly be called upon to pay for such benefits through special taxes. In a year of relatively poor yield like 1935-36, American business taxes produced \$1,500,000,000—14 per cent of the country's tax revenue. Since 1920, business taxes have accounted for between 20 and 38 per cent of the federal government's tax revenue.

Neither the federal government nor any of the states has found

it practicable to develop a single all-embracing business tax—a tax applying to incorporated and unincorporated enterprises, and covering all forms of gainful business activity. A universal business tax based upon gross income or net income might conceivably be levied, but to date, none such has developed. Instead, the American governments levy special taxes on particular classes of business enterprise—on incorporated concerns, on public service corporations, on banks and other financial enterprises, on mining and drilling companies, on specific occupations and professions. Occasionally, these special classes so complement each other that all aspects of business activity are taxed. More often, some class or classes escape special contribution. Quite frequently incorporated enterprises are subject to special taxes which do not burden unincorporated business enterprises.

FEDERAL BUSINESS TAXES ¹

Prior to 1909, the federal government had shown itself disinclined to levy business taxes. On only one occasion—during the Civil War when the federal government sought revenue from every conceivable source—were they enacted. Civil War business taxes fell into three categories—a series of lump-sum license taxes on a multitude of particular occupations; gross receipts taxes on incorporated railroad, bridge, canal, express, stagecoach, telegraph, and insurance companies; and a complicated system of bank taxes which included a capital stock tax, a deposits tax, a tax on capital employed, and a tax on banknote circulation. All were abolished in 1870 when the pressing need for federal war revenue had passed.

Federal business taxes since 1909

Business taxation as a source of federal peacetime revenue was inaugurated with the levy of a federal corporation income tax in 1909. In part, it represented an outcropping of the federal government's general distrust of the activities of incorporated "big business" during the Roosevelt era. To avoid possible constitutional

¹ The best recent study on the subject is Temporary National Economic Committee, *Taxation of Corporate Enterprise* (Monograph No. 9, Washington, 1941).

complications, the tax was called a "corporation excise," but it was none the less a net income tax of the purest sort. Its rate was one per cent. In 1913, to form a general system of federal income taxation, the "corporation excise" was merged with the personal income tax levied under the authorization of the Sixteenth Amendment.

During World War I the federal government relied heavily on a system of business taxation. The corporation income tax rate was increased to 6 per cent in 1917, and to 12 per cent in 1918. A supplementary "excess profits tax" with rates ranging from 20 to 60 per cent was levied in 1917 on the excess of a corporation's profits over a peacetime normal. In the following year the rates of this tax were increased and an additional "war profits tax" established for one year an 80 per cent minimum tax on those classes of corporation income designated as "war profits." Concurrent with the levy of the excess profits tax in 1917, was the enactment of a one-twentieth per cent tax on the capital stock of all corporations. The rate of this capital stock tax was increased to one-tenth per cent in 1918.

From 1918 to 1932, the federal system of corporation taxation was steadily pared down. The corporation income tax rate was reduced to 10 per cent in 1919. In 1921 the excess profits tax was abolished, and only partly compensated by an increase of the income tax rate to 12½ per cent. The capital stock tax was dropped in 1925, the income tax rate being increased to 13½ per cent; three years later this was reduced to 12 per cent.

Shrinkage of federal revenues during Depression and the subsequent increase of federal expenditures to stimulate recovery necessitated resort to heavier business taxation. In 1932 the corporation income tax rate was increased to 13¾ per cent, and the rates of a stock-and-bond issues tax and a securities transfer tax, which had persisted from the War era, were increased. The corporation income tax rate was made progressive in the 1935 revenue act—from 12½ per cent on the first \$2000 of a corporation's income to 15 per cent on the excess over \$40,000. A year later, in connection with the levy of the undistributed profits tax, the rates on small corporate incomes were reduced somewhat. At the same time that these rate

changes were being made, the character of the tax was stiffened—the privilege of making consolidated returns was narrowed, the exemption of intercorporate dividends was limited, and regulations on the calculation of depreciation and depletion were tightened. A combined excess profits and capital stock tax was imposed in 1933, a payroll tax to finance the federal social security program was levied in 1935, and the provocative undistributed profits tax was added to the system in 1936. This last mentioned tax was reduced in 1938 and abolished in 1939; on each occasion the corporation income tax rate was increased.

The “defense” revenue acts of 1940 and 1941 involved additional heavy corporation taxation. Corporation income tax rates were increased in both years, the result was a progressive rate schedule beginning with 21 per cent on the first \$5000 of a corporation’s income and rising to 31 per cent on the entire income of corporations earning over \$25,000. The rates of the combination capital stock and excess profits tax were also increased. In 1940, a new excess profits tax, with rates graduated from 25 per cent to 50 per cent, was imposed. The 1941 act increased the rates of the excess profits tax, bringing the schedule range to 35-60 per cent.

✓ The federal corporation income tax

The income concept is practically the same for the federal corporation income tax as for the personal income tax,² due allowance being made for the circumstance that corporations never receive certain elements of income received by persons. Calculation of gross operating income and of business cost deductions is almost identical, except for insurance companies. A two-year prior loss carry-over, which tends to favor small corporations more than large companies and is an advantage to certain industries such as rubber goods manufacture because of irregularity of income, was allowed from 1918 to 1932, dropped for seven years, and restored in 1939. Capital gains and losses are treated in identical fashion. Tax-

² For an extended analysis of the income concept for the personal income tax, see pp. 431 to 444 of this volume. A sample federal corporation income tax report is reproduced in Appendix E, pp. 828-831 of this volume.

exempt interest is the same for both taxes. Treatment of dividends under the two taxes is divergent. Under the personal income tax, they are exempt from the normal rate, fully taxable under the surtax. Until 1935 they were completely exempt under the corporation tax, and have since then been taxable on a fractional basis. Charitable contributions by corporations are limited to 5 per cent of taxable income, in contrast with the 15 per cent allowed to individuals.

Until 1934, a "parent" holding company was allowed to make a single consolidated return covering all affiliates in which it was dominant stockowner. Losses incurred by some could be offset against the profits earned by others, reducing the taxable income to be reported for the group. But disputes and litigation over this provision were common, and many tax scholars subjected it to sharp criticism on the ground that it favored "big business" and discriminated against independent concerns. In 1932 a supplementary three-quarters per cent tax was imposed on consolidated returns. Two years later the privilege of the consolidated return was withdrawn, except for railroad companies. Motivating this action was partly a desire to make the corporation income tax more productive, partly a resurgence of the anti-trust sentiment which was displaying itself in other legislation of the period.

Only by straining the logic of the distributive principles discussed in Chapter XII can any justification be advanced for the progression introduced into the federal corporation tax rate in 1935 and retained, with a different rate schedule, in the 1938 tax law. Like the minimum exemption that had lasted from 1909 to 1932, its purpose was not distributive justice but regulation. It was part of the Roosevelt program of fostering "little" business in its losing struggle with "big" business.³

³ The Treasury's arguments in favor of corporation tax progression have been summarized as follows: "1) the apparent greater stability of the income of large as compared to small corporations and the consequent stabilizing effect of increased reliance for revenues upon that class of corporations whose income is most stable; 2) the relative smallness of losses as between the groups of large and the groups of smaller corporations, 3) the fairly general tendency for larger corporations to have a higher average return on their gross business than smaller corporations; 4) the steady and continuing increase in the concentration of corporate wealth and the relation between corporate growth and corporate

Supplementary taxes on undistributed corporate profits

If a corporation fails to distribute any substantial part of current earnings as dividends, but instead transfers the amount to surplus, rich shareholders avoid a considerable element of tax liability. Although their net worth is enhanced by the increased value of their shares, they have received no dividend income to be subjected to the heavy progressive rates of the personal income surtax. As described earlier,⁴ wealthy taxpayers have created many personal holding companies for the express purpose of reducing their income tax liability. For twenty-five years Congress has experimented with various methods of plugging these corporation loopholes to the personal income tax.

The revenue acts of 1913, 1916, and 1918 provided that withholding "unreasonable" amounts of corporate profits would make corporations liable for a tax on the undistributed earnings in the same manner as if they had been distributed as dividends. This provision was unenforceable and was eventually held to be arbitrary and hence unconstitutional. A different approach was essayed in the 1917 law, which imposed a special 10 per cent surtax on undistributed profits not reinvested in the business. Subsequent acts set various standards of "unreasonable" withholding of profits, imposed varying penalty rates. A peak rate of 50 per cent was established by the 1924 act. The current rate, set by the 1938 law, is 25 per cent on "improperly retained income" under \$100,000, and 35 per cent on the excess over \$100,000. Personal holding companies are subject to an especially severe punitive tax. Since 1937, their

profits, 5) the numerous advantages enjoyed by large corporate enterprises over their smaller competitors, other than technological efficiency, such as their greater bargaining power and resulting price concessions in the purchase of commodities and services, their ability to buy in and pool important patents, their greater ability through distribution of plants and warehouses to effect substantial savings in transportation costs and to sell in a wider market, and the advantages enjoyed in the facility and cost of financing. Such advantages were regarded as reasons why size provides a useful, if rough measure of benefits received and of ability to contribute to the cost of government and to justify a moderate graduation of corporate taxation"—Arthur H. Kent, "The Federal Tax Program for 1935 and 1936," *Proceedings of the Twenty-Ninth National Tax Association Conference*, 1936, p. 210

⁴ See p. 461 of this volume

"undistributed adjusted net income" has been taxed 65 per cent on the first \$2000, and 75 per cent on the excess.

These punitive taxes have usually failed because of the impossibility of framing a definition of "unreasonable" withholding of profits that would stand the scrutiny of the courts. Recommendations for a general undistributed profits tax without punitive features had been made from 1918 on, and occasional bills to encompass such a tax were introduced during the 1920's. These proposals were aimed at weakening this incentive for personal income tax avoidance, and at equalizing federal income tax burdens on incorporated and unincorporated business. From 1933 on, the suggestion was made, with increasing frequency, that such a tax would check the corporate savings which many writers consider economically undesirable. This last line of reasoning was influential in swinging President Roosevelt's opinion in favor of the tax. His intent was to replace the general corporation income tax with a high-rate undistributed profits tax. Congress passed a more moderate measure, supplementary to the general income tax.⁵

Under the 1936 law, the rates of the undistributed profits tax, from 7 to 27 per cent, were progressive relative to the proportion of "adjusted net income" remaining undistributed at the end of the year. The 1938 tax law reduced the rate of the tax to 2½ per cent, applying only to corporations with incomes in excess of \$25,000. The tax was levied by allowing corporations paying the 19 per cent rate on incomes in excess of \$25,000 a 2½ per cent *credit* on the amount of their dividend distributions. Business and congressional hostility remained unappeased, and a year later the taxation of undistributed corporate profits was dropped completely.

The capital stock tax

In 1916 the federal government levied a capital stock tax, a one-twentieth per cent levy on the capital worth of corporations over a \$99,000 exemption. A year later the exemption was reduced to \$5000 and the rate increased to one-tenth per cent. At its best the

⁵ The best study of undistributed profits taxation is Alfred G. Buehler, *The Undistributed Profits Tax* (McGraw Hill Book Co., New York, 1937).

tax produced approximately \$100,000,000 a year. Probably as much more escaped the Treasury through the understatement of capital worth by the corporations. The task of auditing nearly 350,000 annual returns of corporate capital worth, each far more complicated than any income tax return, was beyond the capacity of the Bureau of Internal Revenue. Repeal of the tax in 1926 occasioned no regrets in any quarter.

The National Industrial Recovery Act of 1933 revived the capital stock tax, wedded in clever combination with an "excess profits tax." Basis of both taxes is a return of "adjusted declared value of capital stock." Once established, this valuation must be continued from year to year, with specific additions or diminutions of capital worth arising out of the year's business. For the capital stock tax, a rate of one-tenth per cent was levied on this "adjusted declared value." "Excess profit" for any corporation under this tax consists of all income in excess of 10 per cent, calculated on the basis of "adjusted declared value of capital stock." Prior to 1940 such "excess profit" was taxed at the rate of 6 per cent on net income between 10 and 15 per cent, and 12 per cent on income in excess of 15 per cent of the capital stock value; in 1940, the rates of both capital stock and excess profits taxes were increased by one-tenth. Corporations are faced with the dilemma that if they underassess their capital value to avoid the capital stock tax, they are likely to render themselves liable in some near future to heavy excess profits taxation, whereas if they establish a high capital worth to avoid excess profits taxation they must pay a continuous high capital stock tax. In practice, it has been to the advantage of corporations to report a capital stock ten times the amount of their anticipated income. The major revenue from the combined levy is produced by the capital stock tax, and the "excess profits tax" serves essentially as a "whipping boy" to its related levy.

For the tax administration the problem of checking returns of capital value is eliminated; the corporations' self-assessments are accepted blandly with confidence that the Treasury, in the long run, cannot lose.

War and defense excess profits taxes ⁶

During World War I a score of countries, the United States among them, imposed "excess profits" or "war profits" taxes. Within a few months of the opening of hostilities in World War II, the leading belligerents had again enacted such taxes. An American "defense" excess profits tax became law in October 1940, was amended and had its rates increased in 1941.

Two major reasons motivate the levy of war and defense excess profits taxes. The first is their substantial yield during a period of war or defense prosperity; during 1917 through 1919 the first American excess profits tax produced \$5,500,000,000, and the budget estimate for the 1940 levy was over \$500,000,000 annually. The second reason is the popular and legislative belief that favorably situated business enterprises should not be permitted to derive extra gains from a national emergency. A possible supplemental motivation for the tax in the minds of some is the view that it penalizes monopoly and "soaks the rich."

The basis of a war excess profits tax is the difference between wartime earnings of a business enterprise and its "normal" earnings. The wartime earnings are readily determined; they are simply copied, with some possible adjustments, from the ordinary income tax return for the taxable year. "Normal" earnings are more difficult to determine. Two procedures have been developed; the present federal tax allows the taxpaying corporation to choose whichever method is more favorable to it. The first method is to take the average earnings for some prewar "base period"—for the American tax, 1936 through 1939—as "normal." The second is to take as "normal" some ratio of earnings to operating capital—8 per cent under the American law.

Each of these methods of calculating "normal" profit has certain disadvantages which constitute the other method's advantages. Against the "base period" method it may be argued that for par-

⁶ See Alfred G. Buehler, "The Taxation of Corporate Excess Profits in Peace and War," *Law and Contemporary Problems*, Vol. VII, No. 2, Spring 1940, pp. 291-300, William J. Shultz, "The Principles of Excess-Profits Taxation," in The Conference Board, *Essential Facts for Fiscal Policy* (the Board, New York, 1941), pp. 68-79. *

ticular firms these years may have been exceptionally favorable, so that with a high "normal" profit, their taxable "excess" profit is correspondingly reduced. Also, the "capital ratio" method must be used anyway for calculating allowances for increases or decreases of capital employed in the business. Against the "capital ratio" method of calculating "normal" profit, it is urged that differences in the risk factor as among lines of business produce differences in the average earnings ratios of the firms that earn a profit. These variations in the risk factor may be taken into account by special allowances granted upon administrative review, but thereby a delicate and dangerous responsibility is lodged with the administrative agencies. Also, the "capital ratio" method of computing "normal" profit raises practically insoluble problems of determining whether borrowed funds should be included in the capital base. Combination of the two methods, as under the American tax, solves the problem by eliminating most discriminations against particular taxpayers, but retains all discriminations that favor any advantageously situated concerns.

Fiscal logic would dictate that an excess profits tax should apply to partnerships and private enterprises as well as to corporations. The American tax has sacrificed fiscal logic to administrative expediency. By limiting the tax to corporations, the federal Bureau of Internal Revenue is relieved of the task of handling returns from scores of thousands of small business units.

Rate schedules for excess profits taxes are always far higher than the rates for ordinary corporation income taxes. One reason is that the excess profits tax, after all, applies to only part—and sometimes only a small fraction—of a corporation's income. A second reason is the popular and legislative feeling that these "excess" profits are a windfall received because of the accident of events rather than the recipient's business deserts. The current British excess profits tax rate is 100 per cent—absolute confiscation. The rate schedule of the 1940 American tax was progressive, with 25 per cent on the first \$25,000 of excess profits, rising to 50 per cent on the excess over \$500,000. In 1941 the rate schedule was increased, with a top bracket rate of 60 per cent on the excess over \$500,000. From a purely fiscal

A third payroll tax, now operative at 3 per cent, is imposed to constrain the states to levy payroll taxes for the financing of unemployment insurance programs, this result is accomplished by allowing state payroll tax payments as a credit on the federal tax up to 90 per cent of the latter. Since all states are imposing payroll taxes to absorb the full amount of the credit, the effective rate of this third federal payroll tax is now .3 per cent.

STATE CORPORATION ORGANIZATION AND ENTRANCE TAXES ⁸

The act of incorporating any sort of business enterprise involves a small expense to the state department performing this function. During the first half of the nineteenth century, newly organized corporations were customarily charged a small flat fee to cover the costs of this incorporation. After the Civil War, the incorporation charge was recognized as a possible source of revenue. The transition from fee to tax was accomplished either by raising the amount of the flat charge above the costs of incorporation, or by converting the flat charge into a capital stock tax. By 1902, forty states levied either fixed or capital stock corporation organization taxes. At present, all states except Georgia and West Virginia tax the organization of domestic corporations.

Prior to the 1890's, foreign corporations registering their entry into a state for the purpose of doing business therein were not subject to any special tax. In 1894, Ohio taxed the "entrance" of foreign corporations on the basis of the amount of capital stock to be employed in the state. Other states followed suit. Only Georgia, Kentucky, and West Virginia are without corporation entrance taxes today.

Current status

As a basis for corporation organization taxes, the fixed or flat tax has generally been supplanted by the capital stock tax. But the

⁸ An organization tax is levied on domestic corporations for the privilege of incorporating. An entrance tax is levied on foreign corporations for the privilege of entering the taxing state to do business. In some states, these taxes are called "charter taxes," "filing fees," "bonus taxes," "capitalization fees," and "initial fees."

former remains a common basis for entrance taxes on foreign corporations because of the apparent hostility of the federal courts toward capital stock entrance taxes. Fixed entrance taxes range from \$10 in Delaware to \$300 in Tennessee.

There are three bases for capital stock taxes—the value of capital stock which corporations are authorized by their charters to issue, the value of capital stock actually issued, and the amount of capital actually invested in the taxing state. Authorized capital stock is the general basis for capital stock organization taxes on domestic corporations. But federal constitutional limitations until recently forced many states to base their capital stock entrance taxes on issued capital stock or on capital employed in the state.

Under the federal courts' earlier construction of the "due process of law" and interstate commerce limitations of the federal Constitution, capital stock taxes on foreign corporations had to be based only on the capital stock of foreign corporations actually invested in business in the taxing state. This restriction did not affect the states whose entrance taxes are based on capital to be employed in the state, but the states levying authorized or issued capital stock entrance taxes had to provide for the allocation of the capital stock of the taxed corporations. Recently the Supreme Court held that an entrance charge imposed as a nonrecurring *fee* rather than a *tax* was not subject to the limitations on entrance taxes.⁹ Property is the usual standard of allocation for entrance taxes. The tax is levied on such proportion of a corporation's capital stock as its property in the state is of its total property. A few states, unwisely perhaps, use a double standard of allocation for entrance taxes—property and gross sales.

Capital stock organization or entrance taxes are most commonly flat percentage taxes. Percentage rates range from one one-hundredth per cent on total authorized stock in New Mexico to one-third per cent of the capital of foreign corporations to be employed in Pennsylvania. Where the same type of tax is levied on both domestic and foreign corporations the rate is usually identical. A few

⁹ *Atlantic Refining Co. v. Virginia*, 302 U. S. (1937) 22.

states discriminate in their tax rates between domestic and foreign corporations.

In order to attract large corporations, some states graduate the rates of their capital stock organization and entrance taxes, applying lighter rates to large than to small corporations. With a similar end in view, many states set minimum and maximum charges for organization and entrance, the former to derive a sizable revenue from small corporations, the latter so as not to discourage large corporations.

STATE GENERAL CORPORATION TAXES

Until late in the nineteenth century, incorporated business other than financial institutions and public service enterprises—the incorporated manufacturers, merchants, butchers, bakers, and candlestick-makers—generally escaped special state taxation. The earliest form of general corporation tax, the corporate excess tax, was not a special tax but a modification of the general property tax to prevent corporations from evading their intangible property taxes.¹⁰ At first this intangible “corporate excess” value was assessed and taxed to the shareholders; subsequently it was universally assessed to the corporations themselves. Massachusetts enacted a corporate excess tax in 1832, but by 1863 only four other states had adopted the innovation. In 1912 corporate excess taxes were levied in sixteen states. Thereafter this form of corporate taxation was looked upon with decreasing favor, and at present only nine states have such taxes on their books.

Although the capital stock corporation tax developed later than the corporate excess tax, it spread more widely. Pennsylvania levied a capital stock franchise tax¹¹ on domestic corporations in 1840.

¹⁰ For analysis of corporate excess taxation under the general property tax, see p. 384 of this volume.

¹¹ The statutory designations of these taxes have been various and often quite meaningless. They are called “franchise taxes,” “license fees,” “privilege taxes,” “corporation fees,” and so forth. For the purpose of study, the statutory nomenclature has been ignored, and the various annual corporation taxes have been classified according to their inherent legal character. The term “franchise tax” has been confined to annual taxes on domestic corporations and “privilege tax” is applied to annual taxes on foreign corporations.

Other states were slow to adopt this form of corporation tax—only twelve states had done so by 1902. Thereafter, the spread of this tax was rapid. At one time, thirty-five states imposed capital stock franchise taxes; now the number is thirty-three. Capital stock privilege taxes on foreign corporations developed later than similar taxes on domestic corporations, but they were soon almost as universal as the capital stock taxes on domestic corporations. These capital stock taxes produce some \$100,000,000 a year—less than three per cent of the states' tax revenues. In the state of Delaware, a "corporation haven" state, the annual corporation taxes account for 30 per cent or more of the state's tax receipts

The corporation income tax is the latest addition to the family of general corporation taxes. A few states—Pennsylvania, Tennessee, and Virginia—experimented with corporation income taxes during the nineteenth century, but without success. Enactment of the federal corporation income tax in 1909 gave an impetus to the movement for state corporation income taxes. Wisconsin levied a successful corporation income tax in 1911. Seven other states passed such taxes during the next decade. At present, thirty-two states have corporation income taxes as substitutes for or in addition to capital stock taxes. These state corporation income taxes yield from \$100,000,000 to \$150,000,000 a year.

Capital stock taxes

Capital stock franchise and privilege taxes have the same three bases as capital stock organization and entrance taxes—authorized capital stock, issued capital stock, and capital employed in the taxing state. There is a marked tendency for taxes based on authorized capital stock to be replaced by taxes with one of the other two bases. Allocation is common in both franchise and privilege taxes based on authorized or issued capital stock,¹² but it is obviously unnecessary for taxes based on "capital employed within the state."

Uniformity in the rate structure of capital stock taxes is conspicuous by its absence. Some rates are stated as a proportional per-

¹² A sample return form for an allocated capital stock tax is reproduced in Appendix E, pp 840-843 of this volume

millage, others as a regressive series of specific charges for specified amounts of capital stock. Some, like Pennsylvania's five-mill tax or South Carolina's three-mill tax, are substantial. Others are trifling—the rate of the Colorado tax on authorized capital stock is one-tenth of a mill, that of Maine from one-tenth to one-fortieth of a mill. Rarely is any serious attempt made to check the returns, and understatement of capital worth by the taxpaying corporations probably robs the states of millions of revenue each year.

Corporation income taxes

All state corporation income taxes are based on earned net income. Unlike the federal corporation income tax, the state taxes frequently do not apply to public utilities, banks, insurance companies, and other groups of corporations reached by special taxes. In defining taxable income, the federal tax provides a general model for most states, but variation in details is wide. For example, most states for constitutional reasons exempt interest on federal securities, but thirteen have framed their taxes as levies "on the franchise or privilege of doing business within the state as a corporation measured by net income thereby earned," or are taking advantage of recent Supreme Court decisions to include such income in regular income taxes. On the basis of this subject-measure loophole, they are taxing "tax-exempt" interest. Capital gains are completely exempt in three states, taxed on a partial basis in another. Dividends received from other corporations are variously treated. Three states do not allow bad debts as deductions, one does not allow the deduction of depreciation reserves. On practically every item entering gross income or calculated as a deduction, one or more states provide exceptions to the general rule.

Under constitutional compulsion, all states provide for allocation of the incomes of foreign corporations. Most of these states also permit allocation of the incomes of domestic corporations.¹³

Six states, motivated by the desire to foster small business enterprises, have corporation income taxes with progressive rate sched-

¹³ A sample return form for an allocated state corporation income tax is presented in Appendix E, pp. 835-839 of this volume.

ules. The other twenty-six state corporation income taxes have proportional rates. The lowest and most common rate is 2 per cent, found generally in states which subject their corporations to a capital stock as well as an income tax. Top rate at present is Oregon's 8 per cent, although Pennsylvania applied a temporary 10 per cent rate to 1936 corporate incomes.

State corporation income taxes have the disadvantage of wide elasticity in revenue yields—in years of prosperity the tax produces an ample revenue, but its yield is trifling in depression years when the revenue is most needed. Massachusetts, New York, and Tennessee stabilize the yield of their corporation income taxes somewhat by supplementing them with alternative capital stock taxes, the corporation paying whichever tax is higher. By the operation of the capital stock tax in this arrangement, an irreducible minimum revenue is assured, even in depression years. A National Tax Association committee has suggested that a supplementary alternative gross income tax might be a better guarantor of minimum revenue than a capital stock tax.¹⁴

Allocation

State taxation of foreign corporations is hedged about with constitutional limitations. A foreign corporation whose activities within the taxing state are indissolubly tied to interstate or foreign business may not be subjected to a capital stock or income privilege tax.¹⁵ If intrastate activity is present, a privilege tax may be imposed, but only upon so much of the capital stock¹⁶ or net income¹⁷ as may be attributed to the taxing state by separate accounting or by some system of allocation. Although capital stock and net income franchise taxes on domestic corporations need not be allocated, nearly all

¹⁴ "Report of the Committee on a Model Plan of State and Local Taxation," *Proceedings of the Twenty-Sixth National Tax Association Conference*, 1933, pp. 391-399.

¹⁵ *Cheney Brothers Co. v. Massachusetts*, 246 U. S. (1918) 147, *Alpha Portland Cement Co. v. Massachusetts*, 268 U. S. (1925) 203, *Anglo-Chilean Nitrate Sales Corp. v. Alabama*, 288 U. S. (1933) 218. But note that the current tendency of the Supreme Court is to avoid wherever possible construing a corporation's business as exclusively interstate—*Atlantic Lumber Co. v. Commissioner of Corporations and Taxation*, 298 U. S. (1936) 553.

¹⁶ *Cudahy Packing Co. v. Hinkle*, 278 U. S. (1929) 460.

¹⁷ *Underwood Typewriter Co. v. Chamberlain*, 254 U. S. (1920) 113.

states make such provision, since many of their domestic corporations would otherwise reincorporate in other states to avoid the extra tax burden.

For capital stock taxes the most common standard of allocation is tangible property—a state capital stock tax is applied to such proportion of a corporation's capital stock as is determined by the ratio of its tangible property in the taxing state to its total tangible property. A few states employ a double basis of allocation—property and gross sales.

More complicated formulas have been developed for allocating net income under state corporation income taxes. Three states utilize the triple allocation basis of tangible property, gross sales, and manufacturing costs. Another six substitute payrolls for manufacturing costs. Various combinations are found in other states; New York allocates corporate income on the threefold basis of tangible property, the average monthly value of certain bills and accounts receivable, and the average value of the shares of other corporations held by the taxed corporation.

As a committee of the National Tax Association pointed out over fifteen years ago:

All methods of apportionment of trading profits are arbitrary—the cutting of a Gordian knot. . . . There is no one right rule of apportionment, notwithstanding that there are probably a number of different rules, all of which may work substantial justice.

The only right rule of procedure is a rule on which the several states can and will get together as a matter of comity. Getting together by the uniform adoption of some equitable method and finding the right rule of apportionment are . . . synonymous.¹⁸

Various national business associations, and the associations of state legislators and state tax officials, as well as the National Tax Association, have repeatedly recommended that the states agree upon a uni-

¹⁸ "Report of the Committee on the Apportionment between States of Taxes on Mercantile and Manufacturing Business," *Proceedings of the Fifteenth National Tax Association Conference*, 1922, p. 201.

form standard of allocation for business taxes. So far, these recommendations have apparently fallen on deaf ears.

STATE TAXES ON RAILROADS AND PUBLIC SERVICE CORPORATIONS

To encourage construction during the early years of American railroading, many states exempted railroad companies from ordinary property taxation. Some states continued this policy of exemption well into the last quarter of the nineteenth century.

The earliest special railroad taxes were not generally applicable to all railroads in a state. Rather, they took the form of individual taxes specified in the charters of the railroad companies. This gave rise to many forms of railroad taxation within a single state, and was soon abandoned for systems of general railroad taxation. Railroad tax systems have not shown the form of progressive development in which a more effective system replaces a less effective one. Instead, the various states have tried one or another system of railroad taxation, sometimes changing systems, sometimes clinging to the one first established. Railroads have been subjected to the general property tax with or without centralized assessment, to gross receipts taxes, to capital stock and bonded debt taxes, to mileage taxes, and to other special taxes.

Telegraph companies developed later than railroads, and it was natural that taxes on such companies should be strongly influenced by railroad taxes. Some states have never withdrawn telegraph companies from the general property tax system. Others provided for the centralized assessment of telegraph property and sometimes for valuation by the "unit rule." With increasing frequency after 1875, the states resorted to gross receipts taxes. A few states turned to mileage taxes, generally proportional, but occasionally graduated by some standard.

State taxes on telephone companies tended to parallel the earlier taxes on telegraph companies, though the rates were often differentiated where the two taxes were otherwise similar. Telephone companies were subjected to centrally assessed property taxes, to gross

receipts taxes, and to mileage taxes. A few states developed a tax based on the number of instruments installed.

After the Civil War, express companies came to the attention of tax-hungry legislatures. More commonly than in the case of railroad, telegraph, or telephone companies, the tendency was to subject express companies to gross receipts taxes. Electric light and power companies came to be taxed generally on a gross receipts basis. Other classes of public service enterprises—pipe-line companies, water companies, steamboat companies—were subjected to special taxation in some states.

These special public utility taxes yield about the same revenue as the state income taxes—around \$140,000,000 a year. For most states they are a minor item of revenue. But in Wyoming and New Jersey they account for one-fifth to one-fourth of those states' tax receipts.

Gross earnings taxes

The gross earnings tax is the distinctive form of public service corporation tax; it is employed in all but four states. It may be applied to all public service enterprises operating in the taxing state, or merely to some, and the remainder taxed by other, special taxes.

Many public utilities gross earnings taxes, particularly those on railroads, are *in lieu* taxes—state levies substituted in the interest of administrative simplicity for general property taxes on the utilities' operating properties.¹⁹ *In lieu* gross earnings taxes may be based upon an allocated fraction of a corporation's total gross earnings, including earnings arising out of both interstate and intrastate services. But the general burden of an *in lieu* gross earnings tax must not be greater than the burden of the property levies for which it is substituted.

Revenues from *in lieu* gross earnings taxes must be distributed among the local governments which would otherwise have levied property taxes on the operating property of the taxed utilities. On this matter, the states were faced with a difficult problem—one which already troubled them if their gross earnings taxes were based

¹⁹ See p. 364 of this volume.

on allocated total gross earnings—the problem of selecting a fair standard of distribution. As an example of the complexity of this problem, some of the standards of allocation and distribution considered for railroad gross earnings taxes have been single-track mileage, total-track mileage, total-track mileage with adjustment for value of terminal property, gross earnings, net earnings, car mileage, train mileage, car and locomotive mileage, “traffic units” calculated on tons of freight hauled and number of passengers carried, value of property. Each standard has minor merits and major disadvantages. And each class of public utility has different possibilities of allocation and distribution standards. Since a National Tax Association committee found it impossible to construct a fair, workable allocation and distribution standard for gross earnings taxes, the state legislatures cannot be severely criticized if they have not succeeded in solving this problem.

Public utilities gross earnings taxes are not always *in lieu* levies; they are often independent taxes imposed in addition to property taxes or even in addition to *in lieu* gross earnings taxes. The entire revenue from such independent gross income taxes goes to the state governments, and hence no problem of distribution standards arises. Nor is there any problem of allocation, since these independent gross earnings taxes may be based only on intrastate receipts.²⁰

Rates of public utility gross earnings taxes vary widely, according to whether they are *in lieu* or independent taxes, according to the class of utility taxed, and according to the will of the various state legislatures. The most common range of rates is from 2 to 4 per cent. In most cases the rates are proportional; a few instances of progressive rates may be found.

Other taxes on public service corporations

Public service corporations are frequently burdened with two or more special taxes, because the states commonly extend to them the general corporation capital stock, income, or corporate excess taxes. Furthermore, the states not infrequently levy special capital stock taxes, net income taxes, or special franchise taxes in the form of cor-

²⁰ *New Jersey Bell Telephone Co. v. State Board of Assessors*, 280 U. S. (1930) 338.

porate excess taxes, on some or all of their public service corporations. Fixed taxes on certain public service enterprises are found in a few states. Southern states frequently tax railroads, streetcar companies, telegraph companies, and express companies according to the mileage of their tracks, wires, or routes. Four states impose kilowatt-hour taxes on electric power companies. Some southern states subject water, gas, and lighting companies, and sometimes other enterprises, to local license taxes based on the populations of the municipalities they serve. Telephone companies in Florida and Tennessee were formerly taxed on the number of instruments installed,²¹ and in Mississippi on the number of subscribers.

Far from uncommon is the subjection of public utility enterprises to several independent taxes in the one state. Some classes of public service corporations in Virginia, for example, are subjected to four special taxes in addition to their property tax. Telegraph companies in that state have to pay five special taxes.

Critique

Gross earnings taxes on railroads and public service enterprises enjoy the great advantage of ease of administration. 'Complicated assessment problems of property taxation,'²² as well as the deduction difficulties inherent in net income taxation, are avoided. But gross earnings taxes are sometimes charged with discriminating among taxed enterprises, overburdening enterprises which suffer losses or have a low ratio of net to gross earnings. It should be remembered, however, that gross earnings taxes on railroads and public service enterprises are quite easily shifted to users. The taxpaying ability of the enterprises themselves need not, therefore, be taken into consideration.

The major flaw in the gross earnings tax is the uncertainty of its legal status. Most of the states using the gross earnings tax hesitate to apply it to an allocated portion of the receipts arising out of interstate commerce lest this be held a violation of implied federal

²¹ This type of tax was held an unconstitutional burden on interstate commerce in *Cooney v. Mountain States Tel. & Tel. Co.*, 294 U. S. (1935) 384.

²² See p. 388 of this volume.

constitutional limitations. A gross receipts tax restricted to intra-state receipts is badly mutilated, and does discriminate between enterprises otherwise identically circumstanced. By levying gross receipts taxes *in lieu* of property taxes, the state can avoid this constitutional difficulty. So generous is the attitude of the courts towards accepting the approximation of the burden of a gross receipts tax with that of a property tax for which it is substituted, that the states have a fairly free hand in developing this species of gross receipts tax.

Net income taxes on railroads and public service corporations are probably shifted quite as fully as property or gross earnings taxes, since rate-fixing bodies view them as costs to be covered in the rates allowed. In this distributive aspect, then, they do not differ greatly from ad valorem or gross income taxes. Moreover, they are not subject to the constitutional disabilities which afflict gross earnings taxes. And two circumstances break down the old charge that they present too difficult an administrative problem. First, the federal corporation income tax in its application to public service corporations is being successfully administered. Secondly, as a step in ad valorem assessment, many state tax commissions make a full determination of the net income of the public service enterprises they assess. It must be granted, however, that it is more difficult to administer a net income tax on public service corporations than a gross earnings tax. Furthermore, a net income business tax is a highly variable source of revenue, heavily productive in years of business boom, and falling off sharply in years of business depression. Also—a practical fiscal point—the states appear disinclined to levy net income taxes with rates high enough to yield as much revenue as can be obtained from gross earnings taxes having average rates. Net earnings taxes on public service corporations must be judged as enjoying no particular distributive advantages over property or gross earnings taxes, as suffering from fewer constitutional limitations than gross earnings taxes, but as offering greater administrative difficulties than gross earnings taxes.

Ad valorem taxation of the operative property of public service enterprises is a costly and inefficient method of taxation. The pres-

ent ad valorem taxes should be replaced by gross earnings or net income taxes levied independently where possible, or else *in lieu* of property taxes. No advantage is gained by subjecting public service corporations to combinations of taxes—gross earnings taxes, plus net income taxes, plus capital stock taxes, plus mileage taxes, plus what-not else. The ideal of administrative simplicity is best satisfied by the levy of a single tax with rates high enough to produce all the revenue required from the group of public service enterprises. Such a single public service enterprise tax may be either a gross earnings or a net earnings tax. As indicated above, each form has certain advantages and certain disadvantages.

Occasionally in the past there has been some advocacy of a hybrid public service enterprise tax, combining the principles of both gross earnings and net income taxation.²³ Maine has already enacted such a tax for railroads based on gross earnings, but the rate is graduated by the ratio of net earnings to gross earnings. Behind this proposal is the argument that such a tax is more equitable than an outright earnings tax. But this argument fails to consider the circumstance that net income as a basis for public service enterprise taxation is no more equitable than the gross income basis, since either tax is shifted. The combination of the two principles adds complication to the Maine railroad tax without any compensating advantage.

STATE BANK TAXES

The earliest special state bank taxes were based either on capital stock or dividends. Georgia, New Jersey, and Massachusetts levied special capital stock taxes on banking corporations in 1805, 1810, and 1812 respectively. Pennsylvania, Ohio, and Virginia imposed bank dividend taxes in 1814, 1815, and 1846 respectively. By 1860, a few other states had passed similar taxes.

In 1864, as recounted in an earlier chapter,²⁴ the National Banking Act established a new pattern for state bank taxation—general property taxation of bank shares to the issuing banks. Until the Supreme

²³ See F. R. Fairchild, "Gross-Net Earnings Tax for Railroads," *Connecticut Industry*, September, 1928, p. 13.

²⁴ See p. 385 of this volume.

Court upset this system by the *Merchants' National Bank* decision²⁵ in 1921, no alternative method was considered. Immediately after this ruling was handed down, an organization of state tax officials—the Association of States on Bank Taxation—was organized to promote a liberalizing amendment of national banking law. After stormy debate, R. S. 5219, the section of the federal code which governs national bank taxation, was revised to authorize two additional alternative forms of national bank taxation: (1) taxes on the net income of banks at rates no higher than on other financial corporations or business corporations, and (2) bank dividend taxes at rates no higher than on personal income from other forms of investment. But these methods of bank taxation were not available to states which did not have personal or corporation income taxes, and in 1926 Congress again amended R. S. 5219 to permit states to levy special bank excises “measured by net income.”

These concessions were far from satisfying the states, however, for the taxes which could be imposed under the alternative provisions were much lighter than the outlawed bank share taxes. At the Congressional hearings conducted in 1928, 1930, 1931, 1933, and 1934, the representatives of the banks and the states presented their divergent views as to the necessity for another amendment to R. S. 5219. Efforts of the banks and the tax officials to iron out their differences by negotiation appeared to be successful in 1930 and again in 1932, but the compromise bills agreed upon by the representatives of some states failed to meet the approval of the tax officials in other states. Faced with this disagreement among the states, Congress washed its hands of the issue.

Thirty-three states still cling to the bank share tax, and avoid constitutional difficulties by taxing the shares at low mill rates. Thirteen states tax the income of both national and state banks; eleven of them take advantage of the 1925 bank “excise” amendment, which enables them to include the interest on tax-exempt securities in the income base. In general these newer bank taxes produce much less income than the old general property rates on bank shares. Some discrimination is to be noted as between national and state

²⁵ *Merchants' National Bank v. Richmond*, 256 U. S. (1921) 635

banks. Twenty-eight states impose supplementary levies on the latter that cannot constitutionally be applied to national banks.

Bank income taxes

Of the twelve income taxes levied on both national and state banks, two—those of South Carolina and Wisconsin—are identical as to base and rate with the general corporation income taxes of these states. For the other ten bank excises, the base differs from that of the states' corporation income taxes in one important particular—interest on federal and other tax-exempt bonds is subject to the bank tax.²⁶ In several cases the bank excise rates are somewhat higher than the states' general corporation tax rates, since the burden of the bank excises is intended to balance the burden of the corporation income tax plus capital stock taxes and other levies to which general business corporations in those states are subject.

Besides these twelve states, eight others tax state but not national banks under their general corporation income taxes.

Other bank taxes

Seventeen states extended their general corporation capital stock taxes to state banks and certain other classes of financial institutions. A few states apply gross income taxes to state banks and trust companies.

Deposits in savings and commercial banks are subjected to special mill taxation in a number of states. The rate range of these deposit taxes is from one mill in Kentucky and North Carolina to five mills in Maine, Massachusetts, New Hampshire, and Vermont. Savings deposits of nonresidents are usually exempted from these taxes.

²⁶ Under the "rule of subject and measure," these income excises have been upheld when they applied to interest on federal debt issues (*Educational Films Corp v Waid*, 282 U. S. (1931) 379), and when applied to the interest on bonds issued by the taxing state itself as "exempt" (*Pacific Co., Ltd v. Johnson*, 285 U. S. (1932) 480).

CHAPTER XXI

Taxes on Business (*Concluded*)

STATE TAXATION OF INSURANCE COMPANIES

FOREIGN insurance companies were early selected for special taxation, usually on the basis of premiums collected. New York levied a 10 per cent premium tax on foreign fire insurance companies in 1824. Vermont enacted a similar 5 per cent tax in 1825. Massachusetts passed a retaliatory tax of one-half per cent on amounts insured in Massachusetts by companies incorporated in states which imposed discriminatory taxes on Massachusetts insurance companies. In time the tax was extended to domestic fire and life insurance companies. By 1850 practically all states imposed special taxes on insurance companies of one class or another.

Present status

Gross premiums, less returned premiums and premiums paid on reinsurance, are the preferred basis for state insurance company taxation. Capital stock as a basis for taxing mutual companies which have no capital stock value is out of the question, and as a basis for taxing stock companies, it is far from satisfactory since it fails to reflect the asset values of their reserves. Net income is almost impossible to determine for mutual companies, and is a questionable concept for stock companies.

All states tax foreign fire insurance companies on a premiums basis, and all states except Massachusetts apply a premiums tax to foreign life insurance companies. Somewhat less than two-thirds of the states also bring domestic insurance companies under special premium taxes; the remainder subject them as best they may to general corporation capital stock or income taxes. Premium tax rates vary considerably—from 0.35 per cent on domestic life insurance

companies in New Jersey to 3 per cent on all insurance companies in Idaho. Most common is the 2 per cent rate.

Insurance companies of different classes are frequently taxed at different rates and sometimes under different taxes. Such discriminations are established between life, fire, marine, and casualty insurance companies. Stock companies are frequently taxed more heavily than mutual companies. Fire insurance companies in nearly half of the states are subject to a special tax—the “fire marshal or fire department tax,” levied on the benefit principle for the support of state or local fire departments.

A number of states discriminate against foreign insurance companies, sometimes by levying higher premium tax rates on them, sometimes by subjecting them to premium taxes while domestic companies pay lighter capital stock or income taxes. With the development of reciprocal and retaliatory provisions in insurance tax laws, this type of discrimination is being eliminated.

SEVERANCE TAXES

A severance tax is a special gross receipts or gross product tax imposed on the extraction or “severance” of natural resources—mineral ores, coal, oil, and timber. In some cases these severance taxes have been levied in substitution for property taxes on the current value of the mine or well reserves or timber stands. Application of property taxes to natural resource values promotes wasteful exploitation of mineral deposits and timber stands subject to annual taxation. As the National Resources Board pointed out in its 1934 report:

Owners of mineral resources are driven to open mines in order to provide income enough to meet their taxes, and the ad valorem tax has been one of the causes of overdevelopment of mine capacity, especially of coal mines. It has a tendency to force selective mining, with attendant loss of low-grade material. It handicaps the development and extraction of the miscellaneous grades to be found in most mineral districts. It puts a premium on the use of methods of extraction which cost the least, regardless of the fact that these methods often involve the permanent destruction or locking up of important reserves costing more to extract.

Promotion of deforestation by the application of property taxes to timber lands is even more marked. Substitution of severance taxes for property taxes on natural resource values promotes conservation. Furthermore, in many of the oil and mining states there has risen the feeling that operators who tap the natural resources of the state are gradually yet, none the less steadily impoverishing the state for their own profit. From this feeling have developed several systems of "compensatory" severance taxes levied in addition to the ordinary property and business taxes paid by the mining and oil companies.

As far back as 1846, Michigan imposed an experimental severance tax. But most of the development in this field occurred during the 1920's and 1930's. Thirteen states now impose severance taxes on mining companies, eight states apply such taxes to coal companies, thirteen to oil companies, and fourteen to lumber companies. All severance taxes on timber cutting are gross receipts taxes, based on the stumpage value of the cut timber, with rates varying between 5 and 12½ per cent. About half the severance taxes on mineral, coal, and oil companies are also gross receipts taxes with rates ranging from one-eighth per cent to 6 per cent. The other severance taxes have specific rates, as 1½ cents per ton on coal in Alabama and four-tenths cent per ton in Colorado, or one-half cent per barrel of oil in Oregon, and four-elevenths cent per barrel in Louisiana.

Severance taxes are an important revenue item for some of the states with mineral, petroleum, or timber resources. In 1940, Texas obtained \$18,500,000—13 per cent of the state's revenue—from this source; Oklahoma's \$8,300,000 severance tax yield was also 13 per cent of the state's tax collections.

BUSINESS LICENSE TAXES ¹

Without exception, every state levies special license taxes on one or more particular businesses and occupations. Many southern states

¹ Many state charges on special occupations prove, on close inspection, to be fees rather than taxes—their yield barely covers the costs of the regulatory activity to which they are attached. Such license fees are eliminated from present consideration, but are analyzed in Chapter XXIV, p. 610 of this volume.

Also excluded from present consideration are license taxes on the manufacture or sale of particular commodities which are measured by the number of units or the values produced or sold. These are considered commodity taxes, and are studied in Chapter XXII.

have attempted to cover every possible business activity and occupation with a special tax of some form. In several of these states business license taxes practically constitute a system of special business taxation with differentiated bases and rates. Special business license taxes elsewhere represent a rather casual tapping of incidental sources of revenue.

Liquor license taxes

From earliest times, special state and local license taxes have been levied on liquor manufacturing and distribution. During the Prohibition era, of course, all such liquor license taxes went by the board. But when Prohibition was repealed, all states which did not maintain local prohibition or institute state liquor monopolies hastened to enact new liquor license taxes. Mass consumption of distilled and fermented liquors makes such taxes a certain source of substantial revenue. Complementary to the revenue motive behind these taxes, and sometimes even superior to it, is the intent to regulate and even repress an activity still subject to some social stigma.

Excluding from present consideration those liquor taxes levied upon the volume or value of production or sale which are classified as commodity taxes and analyzed in the next chapter,² we find that most liquor license taxes are levied in lump sum form. Liquor manufacturers pay \$500, or \$1000, or \$2000, or \$2500, or even \$7500, according to the state imposing the tax. Wholesale distributors pay smaller amounts, retailers and various classes of dispensers still smaller sums. Sometimes the taxes on retailers and dispensers are graduated according to the population of the community in which the dealer is located. Most nonprohibition states authorize their local governments to impose additional license taxes on retail liquor dealers and dispensaries.

One curious development in recent liquor license tax legislation is the development of "state protectionism." In an endeavor to foster domestic wine and liquor industries, nearly all of the states have imposed special license taxes on out-of-state producers selling to in-

² See p. 560 of this volume.

state wholesalers, and in some cases they impose extra license taxes on in-state wholesalers who handle out-of-state products.

License taxes on merchandising

One of the oldest and most common of the special merchandising license taxes is the tax on peddlers. Peddlers' taxes are found throughout the country, although their bases differ widely from state to state. Sometimes the tax is a fixed tax, and its payment permits the peddler to sell throughout the taxing state. In some states, the peddler must pay a separate tax for each county in which he operates. In other states, the charge is graduated according to the merchandise he sells.

A number of states levy a special license tax on the sale of cigarettes, cigars, and tobacco products. Most common is a flat tax without any elements of graduation. Tobacco dealers in a few states³ are taxed according to the population of the municipality of their location. Wholesale tobacco dealers are occasionally taxed according to their gross receipts. Sellers of soft drinks too are frequently subject to special license taxes, usually in the form of a fixed tax. Indicative of the political influence of the dairy interests are the special taxes which many states levy on the vendors of margarine and other butter substitutes.

License taxes on manufacturing

Special taxes on manufacturing are less common than special license taxes on merchants. Most widespread of the special manufacturers' taxes is the tax on bottling companies. Usually this tax is of the fixed variety, although production capacity is occasionally used as the basis. These taxes on bottling companies are closely related to the beverage taxes found in some states. Both seek to make the consumption of soft drinks a moderate source of state tax revenue.

Among the other classes of manufacture sometimes subjected to special license taxes are the manufacture of butter substitutes, the

³ The dealers' license taxes are to be distinguished from the tobacco excises discussed on p. 561 of this volume.

canning of meat and fish, cotton processing, and tobacco processing. While the form of the tax on these classes of manufacture varies, the license tax is ordinarily levied as a fixed charge. Other bases used are the value of the plant and fixtures, and the number of brands registered by the manufacturer

License taxes on service enterprises

Various classes of service enterprises are subjected to special license taxes in a number of states, particularly in the South. Warehouses and cold-storage warehouses, employment agencies, hotels and restaurants, moneylenders and pawnbrokers, are among the classes most usually taxed. Warehouses and cold-storage warehouses generally pay either fixed taxes or taxes based on the service capacity of the warehouse. Employment agencies, moneylenders, and pawnbrokers are taxed either by fixed taxes or according to the population of the municipalities wherein they operate. Restaurants are taxed by fixed taxes, according to the population of the municipality in which they are located, according to the number of customers they can serve, or by some combination of these tax measures. Hotels are nearly always taxed according to the number of their rooms or beds.

Commission merchants dealing in farm products, real estate brokers and their salesmen and agents, and stock brokers and their customers' men must frequently pay special license taxes. Brokers dealing in futures are sometimes chosen for special discriminating taxes. Taxes on brokers and agents are usually levied as fixed taxes.

Some of the license taxes on moneylenders and employment agencies are interesting examples of the use of taxes for nonfiscal purposes. Many states restrict their taxes on moneylenders to individuals or firms charging over a specified rate of interest on small loans—usually under \$300. Clearly, the tax law is intended to discourage the making of small loans at extortionate interest rates rather than to yield a tax revenue. Similarly, several states levy sumptuary license taxes on employment agencies handling immigrant labor. In Virginia and West Virginia, such agencies are taxed a flat \$5000 per year.

Amusement taxes

Because of their luxury character, amusements are viewed in many quarters as ideal subjects for special state taxes. There can be no doubt that the sumptuary element enters into the levy of some amusement taxes, such as those on pool and billiard parlors and on race tracks; the Maryland tax on race tracks, for example, is \$6000 for each day on which a race is held. Circuses are a favorite subject for state license taxes. Sometimes they pay fixed taxes, occasionally the tax is graduated according to seating capacity, sometimes it is measured by the number of days the circus gives performances, sometimes by the number of rings or side shows, and sometimes by the number of transportation vehicles used. Moving picture shows and theatres are frequent targets of special tax laws, the tax depending usually upon the population of the city wherein the picture house or theatre is located or upon its seating capacity.

A special class of amusement tax, the pari-mutuel tax, has recently surged into prominence. Eighteen states take either a percentage of the total horse race bets placed through pari-mutuel systems, or a percentage of the "taking" of the racing association. When the tax is on the gross total of bets placed, the rate may range from one per cent to 10 per cent. Rates on the associations' "takings" are naturally much higher; the Ohio tax has a progressive schedule rising from 10 per cent on the first \$1000 to 30 per cent on the excess over \$20,000.

Miscellaneous license taxes and excises

Among the miscellaneous state license taxes, two—those on advertising and on the use of trading stamps—deserve special mention.

In recent years, outdoor advertising signs have become a favorite subject for special taxation. As a form of property they frequently have great value, yet they commonly escape the general property tax. Furthermore, it is argued, billboards in most cases derive their location value from the circumstance that the state has expended

large sums to construct costly motor highways. On this basis, any billboard tax has the support of the "benefit" doctrine of taxation. An important nonfiscal motive has also been urged for billboard taxation. Billboards, it is felt, are a nuisance which should be forced from the roadsides, and a billboard tax is an ideal means to such an end. Moved by these various considerations, a dozen states have in recent years levied special license taxes on billboards and other forms of outdoor advertising.

Critique

Special business license taxes have little justification. Lightning rod agents, dealers in musical instruments, cotton processors, or theatres are granted no special privileges by the state to justify special taxes according to any benefit theory. Because of finespun distinctions drawn between different business activities and occupations, concerns can slip between classifications and avoid the tax in a manner not possible under a more general business tax. No legislative adjustment of fixed taxes, or taxes per county, or taxes per population of the city in which the business is operated, or taxes per machine employed, can make a series of license taxes conform as closely with the principle of taxpaying ability as does a general income tax or some other general business tax. A committee of the National Tax Association has reported concerning these license taxes:

They are regarded as a curse. They are often so onerous that they prevent the extension of business to the communities in which they are levied and thus retard the economic growth of localities that are most in need of development. In the long run, they impair the growth of taxable wealth and thus tend to reduce state and local revenues.⁴

Historical accident gave rise to the license tax systems found in the southern states, but as investigating bodies in several of these states have pointed out, historical accident does not justify their continuation.

⁴ *Bulletin of the National Tax Association*, Vol XII, p 113.

CHAIN STORE TAXES

In 1927—three states—Georgia, Maryland, and North Carolina—imposed special discriminatory taxes on chain stores. In support of these taxes, some argument was made that chain stores had special taxpaying ability, because of their higher efficiency and the intangible value represented by their organization setup. Also, it was suggested, the personal property tax in these states discriminated in favor of chains and against independent merchants, so that the chain store tax was a sort of compensatory levy. Actually, as everybody recognized, the motivation of these taxes was purely regulatory—to hamper the chains in their competition with the independent dealers.

Of the six chain store taxes enacted in 1927 and 1928, five were declared unconstitutional on one or another ground. In these and later decisions, however, the Supreme Court established a permissible scope for this form of taxation. The basic principle of a discriminatory tax on chains was held a permissible form of tax classification.⁵ Graduation of the tax rate by gross income⁶ and a tax discriminating between intracounty and intercounty chains⁷ were disallowed. Graduation by the number of chain outlets in a state⁸ or in the entire country⁹ was upheld. With constitutional issues cleared, many states hastened to place chain store taxes on their statute books. In 1933 alone, 225 chain store tax bills were introduced into state legislatures, thirteen were passed, and the number of states with chain store taxes increased from nine to seventeen. As of 1939, twenty-two states and nineteen cities had chain store taxes.

In general, the chain store tax is like a license tax on merchandising enterprises, in the form of a lump sum tax per store graduated either by the number of stores in the state or in the country. Top rates range from Montana's moderate \$30 for each outlet in excess of ten to Texas' \$750 for each outlet in excess of fifty. Ten-

⁵ *State Board of Tax Commissioners v Jackson*, 283 U S (1931) 527.

⁶ *Stewart Dry Goods Co v Lewis*, 294 U S (1935) 550.

⁷ *Louis K Liggett Co v Lee*, 288 U S. (1933) 517

⁸ *The Great Atlantic and Pacific Tea Co v. Morrisett*, 284 U S (1931) 584; *Fox v. Standard Oil Co of N J*, 292 U S (1935) 40

⁹ *The Great Atlantic and Pacific Tea Co v Grosjean*, 301 U S (1937) 412

nessee has a curious tax based on floor space area. Georgia has a supplementary tax on mail-order sales outlets with a rate ranging from \$2000 for a single outlet to \$10,000 for each outlet in excess of four.

Chain store taxes yield little revenue—the total yield for all states with such taxes in 1940 was only \$5,000,000. But that these taxes check the development of chain merchandising in the states wherein they are levied is unquestionable—and this is their specific purpose. In some cases national chains have simply closed their outlets in heavily taxing states, and have left an unchallenged field to the independents. In other cases they have sold their outlets to the former managers, and have reorganized their distributive system on a “voluntary chain” basis in a manner to avoid tax liability.

Impartial fiscal opinion generally disapproves of chain store taxes. Some authorities, hostile to regulatory use of taxes, condemn chain store taxes on this ground alone. Others, who condone regulatory taxation, argue that the purpose in this case is economically undesirable. One recent study on the subject concludes:

These statutes (the chain store tax laws) fail miserably to accomplish either the purposes expressed by the legislators or any other reasonable goal which might be expected to exist. The passage of chain-store-taxing statutes can be explained only on political grounds. Economic or social factors are far in the background, dominated by factors of political strategy.¹⁰

GENERAL UNINCORPORATED BUSINESS TAX

In nearly all states, incorporated business enterprises bear a heavier tax burden than unincorporated concerns. This discrimination has often been criticized, and the suggestion made that a compensating tax be imposed on unincorporated business. In 1921 Connecticut imposed the first such tax. Because it was felt that the inadequate accounting records kept by many small concerns would make a net income tax difficult to report and administer, a gross income basis was chosen. Rates were set at one-tenth per cent on manufacturing

¹⁰ Maurice W. Lee, *Anti-Chain-Store Tax Legislation* (University of Chicago Press, Chicago, 1939), p. 61.

and retail business, and one-fortieth per cent on wholesale concerns.

New York made the bold plunge in 1935 of enacting a net income unincorporated business tax. Professional and personal service firms, which derive most of their income from services rendered by the owners, are exempt. On other enterprises, the rate is 4 per cent on net income over a general \$5000 exemption plus as many additional \$5000 exemptions as there are co-proprietors or partners.

Theoretical considerations give a strong balance of argument in favor of unincorporated business taxation. The stumbling block which has checked their enactment is the difficulty of administering a tax applying to a myriad of small concerns. Connecticut sought to avoid this difficulty by use of the simple gross income base. New York took refuge in minimum exemptions so generous that only some seven thousand firms are liable for the tax. Neither solution is satisfactory, and whether a substantial but practicable unincorporated business tax can be developed remains an open question.

EMPLOYER PAYROLL TAXES ¹¹

As recounted earlier,¹² the Social Security Act of 1935 provided for payroll taxes on both employees and employers in covered occupations to finance the federal government's old-age pension program. Under the 1939 amendment, the rate of the employers' tax, identical with the levy on employees, is one per cent on wages and salaries under \$3000 for the period 1937-42; thereafter rising by a series of increases to 3 per cent during and after 1949. The Social Security Act further provided a second federal payroll tax on employers of eight or more, against which was allowed a 90 per cent credit for state payroll tax payments, expressly to coerce the states into levying payroll taxes to finance unemployment insurance. For this second federal payroll tax the rate was one per cent in 1936, 2 per cent in 1937, and 3 per cent thereafter.

Every state now has an employers' payroll tax to take advantage of the federal tax credit. With but one exception, their rates exactly

¹¹ See Ralph I. Compton, *The Social Security Payroll Taxes* (Commerce Clearing House, New York, 1940).

¹² See pp 77 and 465 of this volume

cover the credit. Michigan has established full 3 per cent rates, so that employers in this state pay a total 3.3 per cent under the combined federal and state taxes. All but eleven of the state unemployment insurance laws provide for the abandonment, after 1941 or 1942, of the uniform 27 per cent rate in favor of a "merit rating," thus establishing the payment as an insurance premium rather than a tax. Generally, these "merit rating" clauses cover a lowering of the tax for firms with a good employment record, and an increase of the rate for employers whose accounts are charged with greater unemployment benefit payments than their payroll tax payments of the preceding year. A "merit" rate reduction can be claimed as part of the 90 per cent credit against the federal payroll tax.

These payroll taxes in 1940 occupied second place in the states' revenue systems. Only gasoline taxes had a larger yield. For industrial states such as Connecticut, Indiana, Massachusetts, Michigan, New Jersey, New York, Ohio, Pennsylvania, and Rhode Island, they constituted one-quarter or more of the net revenue of the state governments. For Rhode Island, the proportion was 38 per cent.

CONSTITUTIONAL LAW OF BUSINESS TAXATION

Express or tacit permission given by the state to individuals or associations to engage in various lines of business is viewed by the courts as a privilege which will sustain special taxes on the resulting business activities. Furthermore, the conduct of business generally, and such specific aspects of business as purchasing, selling, earning business profits, and so forth, are considered activities which may be subjected to excises. Special business taxes of all forms thus have ample legal basis.

Neither the "equal protection of the laws" limitation of the Fifth and Fourteenth Amendments nor the majority of state "equality and uniformity" constitutional provisions, bar the classification of business enterprises according to form of organization or type of business activity. Nor do they prevent the levy of distinct taxes or different rates on the various classes of business enterprise. Corporations, for no other reason than that they are corporations, may generally be taxed differently from private enterprises. Public service

concerns, banks, mines, insurance companies, may each be subjected to a separate system of taxation. Manufacturers may be taxed differently from merchants, butchers from bakers, steamfitters from plumbers, chain store systems from private retail establishments. The courts ask only that there exist some reasonable economic or legal distinction between two business enterprises to uphold differences in their treatment under the tax laws.

Federal business taxes

The most important constitutional limitations on the federal government's power to levy business taxes were reviewed in an earlier chapter.¹³ It will suffice here to repeat that the federal government cannot tax export trade or gross receipts derived from export trade, nor can it tax state property or the instrumentalities of state government. In connection with business taxation, the most difficult constitutional questions arise from the levy of state and local taxes.

State business taxes

Constitutional law distinguishes sharply between domestic and foreign corporations as to the care with which it guards them from questionable exercise of state and local taxing powers. Corporations are deemed to be the creatures of the states under whose laws they are organized, and the tax powers of states with respect to domestic corporations are plenary. The states are accorded no such absolute power over foreign corporations, and their taxation of such corporations is hedged about with restrictions. Organization taxes on domestic corporations may be based on total authorized capital stock;¹⁴ entrance taxes on foreign corporations, on the contrary, must be based on allocated issued stock or on capital employed in the state.¹⁵ Franchise taxes on domestic corporations may be based on total authorized capital stock¹⁶ and on nonallocated net income; privilege taxes on foreign corporations must be measured by allocated issued

¹³ See pp 205 ff of this volume

¹⁴ *Ashley v. Ryan*, 153 U. S. (1894) 436

¹⁵ *Looney v. Crane Co.*, 245 U. S. (1917) 178, *Cudahy Packing Co. v. Hinkle*, 278 U. S. (1929) 460

¹⁶ *Kansas C. M. and B. Railroad Co. v. Stiles*, 242 U. S. (1916) 111

stock or by allocated net income.¹⁷ Finally a franchise tax may apply to a domestic corporation whose sole business is interstate commerce,¹⁸ but a privilege tax on foreign corporations may not be so extended.¹⁹

Constitutional limitations with respect to gross income or earnings taxes are strict. Receipts arising out of transactions in interstate commerce may not be taxed under a gross receipts tax levied as a state privilege tax.²⁰ Even the common practice of taxing allocated gross receipts arising out of interstate commerce is of doubtful constitutionality. However, if a state levies a gross income tax on public service corporations *in lieu* of a property tax on their property, the tax may be measured by interstate as well as intrastate receipts.²¹ The only limitation upon such a gross receipts tax is that the total burden of the tax must not greatly exceed the burden which would be imposed by the property tax it replaces.

ADMINISTRATIVE CONSIDERATIONS

In general, business taxes are somewhat easier and cheaper to administer than personal taxes. All but the smallest business concerns keep better records on their transactions and finances than do ordinary individuals. These records facilitate the computation of tax liability and reduce the likelihood of error, and they simplify the task of checking the tax returns when such checking is necessary. The complexity of the structure and operations of some concerns is so great, however, that inquiry into their returns to check on possible tax avoidance is an administrative task of supreme difficulty and high cost.

Business concerns are, moreover, less inclined towards tax evasion

¹⁷ *Looney v Crane Co.*, 245 U. S. (1917) 178, *Airway Corporation v Day*, 266 U. S. (1924) 71, *Cudahy Packing Co. v Hinkle*, 278 U. S. (1929) 460

¹⁸ *Detroit International Bridge Co. v Corporation Tax Appeal Board of Michigan*, 287 U. S. (1932) 295

¹⁹ *Cheney Brothers Co. v Massachusetts*, 246 U. S. (1918) 147, *Alpha Portland Cement Co. v Massachusetts*, 268 U. S. (1925) 203, *Ozark Pipe Line Co. v Monier*, 266 U. S. (1925) 555

²⁰ *Oklahoma v Wells, Fargo and Co.*, 223 U. S. (1912) 298, *New Jersey Bell Telephone Co. v State Board of Taxes and Assessment*, 280 U. S. (1930) 338

²¹ *United States Express Co. v Minnesota*, 223 U. S. (1912) 335; *Cudahy Packing Co. v Minnesota*, 246 U. S. (1918) 450, *Northwestern Life Insurance Co. v Wisconsin*, 247 U. S. (1918) 132,

than are individuals. Since most business men are persuaded, rightly or wrongly, that they can pass their taxes on to the purchasers of their commodities or services, they are less inclined to impede levies whose burdens are thought to rest on others. Even where a particular line of business is singled out for discriminatory taxation, as was the automobile business in the early postwar years by federal excises on automobiles and automobile parts, it may make public protest against the tax, but it makes no special efforts to evade it.

While business concerns will not ordinarily attempt to evade the taxes levied upon them they will not hesitate to seek means of avoidance. The business man who is alert to find legal ways of outwitting his business competitors can see no reason for overlooking any loophole afforded him in the tax laws. To aid him in this endeavor, he has the advice of legal counsel, expert at picking flaws in statutes and finding jokers in court decisions. If a tax law minutely classifies business enterprise, and burdens some classes more lightly than others, the business man will leave no stone unturned to make his concern conform as closely as possible with the classes of business activity subjected to the low tax rates. If there is a possibility that some constitutional provision may protect his concern from a particular tax levy, the business man will make the most of that possibility.

Hence, in the levy of a business tax it is above all else essential that the statute be worded in simple, inclusive, unequivocal language. Distributional considerations which dictate special treatment of particular classes of business activity must often be scrapped, lest such special treatment prove a breach in the uniform front of the tax statute and permit the escape of concerns intended to be subject to the full application of the tax. Legislative committees concerned with drafting business tax statutes, and administrative bodies charged with drafting regulations for the assessment and collection of the tax, might well turn an open ear to the advice of industrial and business organizations interested in obtaining a tax law uniform and fair in its application to its members.

Business tax laws and the regulations concerning them should be

so composed that a minimum labor of reporting is imposed on the taxpaying concerns. To require business concerns to report details of their organization and finances unessential to a determination of their tax liability puts them to unnecessary trouble and provokes resentment. Reduction of business tax "compliance costs" is as vital a goal for tax administrators as paring the direct costs of administration.

Intrastate uniformity²²

Complexity in a state's method of business taxation multiplies administrative problems, for the administrative agencies as well as the taxpayers, and the possibilities of tax avoidance are multiplied. As has already been recounted, when various types of business enterprise are subjected to different taxes resulting in higher and lower tax burdens, many firms will employ legal subterfuges to place themselves in the lower-taxed category. Sometimes the subterfuge can be outlawed by litigation—to the expense and irritation of both parties. But often, when statutes are carelessly drawn, the courts uphold the subterfuge, and the avoidance is stamped with judicial approval. All too frequently, the subterfuge never comes to the attention of the tax administration, and is successful in fact if not in law. Furthermore, scattering the attention of the administrative agencies over a dozen or a score of separate business taxes prevents the economies resulting from uniform regulations and large-scale handling of tax returns.

Because of these considerations, many students of taxation advocate the substitution of a general business tax for the series of special business taxes now found in many states. The National Tax Association has been an outstanding champion for the principle of uniform intrastate business taxation.²³ One single general state business tax, applying uniformly to manufacturing, mercantile,

²² A general discussion of interstate tax uniformity is presented in Chapter XXX, p. 746 of this volume.

²³ The National Tax Association's model tax law is directed at intrastate as well as interstate tax uniformity—see "Second Report of a Plan of a Model System of State and Local Taxation," *Proceedings of the Twenty-Sixth National Tax Association Conference*, 1933, pp. 353-420.

and service enterprises, to financial institutions, and to public service enterprises, is not necessarily recommended. Constitutional and economic considerations may dictate differing tax treatment for these broad categories of enterprises. And special regulatory taxes, such as the levies on chain stores and on the liquor business, cannot be fitted into a uniform business tax system. But at the most, four or five basic forms of business taxation could be established within each state, with uniform application of each class of tax. Incidental business license taxes, unless imposed for specific regulatory purposes, or systems of arbitrary license levies like those found in the southern states, are especially condemned.



THEORETICAL CONSIDERATIONS

Because of the diverse forms and characters of American business taxes, no single theory of incidence, no single distributive argument, can be applied to them. Rather the whole body of economic and distributive theory has to be drawn upon to throw light on the various problems presented by this group of taxes.

Incidence

Economic theory has long posited that a net business income tax cannot be shifted, that its incidence is on the taxed concern.²⁴ On traditional argument, then, it might be concluded that the federal corporation income tax, to the extent of its application to manufacturing, mercantile, and service enterprises, is not shifted. This conclusion is further buttressed by the consideration that the federal corporation tax imposes a heavier burden on incorporated enterprises than does the federal personal income tax on their unincorporated competitors, and that a discriminatory tax cannot be shifted. Deductive theory on this subject was confirmed by an inductive study made about a decade ago of the sales, profits, and capitalization of American corporations. The conclusions of this study with respect to the incidence of the federal corporation income tax on manufacturing, mercantile, and service enterprises were:

²⁴ See p. 252 of this volume.

Since the market price (of the goods sold by competitive manufacturing and mercantile corporations) depends on the expansive and contractile character of the large volume tendered on the market around the no-profit point, it is obvious that the price is determined by the portion of the output, the production of which is not affected by the (federal corporation income) tax. The tax will not affect the expansive or contractile character of any portion, because the product sold at a loss or at no profit is not subject to the tax, and the portion sold at a profit will still be profitable after a tax proportional to the profits is deducted. The corporation income tax, therefore, appears to offer no new or additional factor in price determination. . . . What shifting is done is small in total amount and occurs under exceptional conditions, and it does not seem to make much difference whether short or long periods of time be considered.²⁵

As to the incidence of the federal excess profits tax, there can be no question whatsoever. This is a tax on "economic surplus" of the purest form, and hence absolutely unshiftable.

But for one feature, state corporation income taxes could be established as unshiftable by the same arguments that apply to the federal tax. Several of the state corporation income taxes, as was indicated earlier, have supplementary capital stock taxes attached to them to establish minimum tax payments in years when corporations earn no net income. Corporations which pay the minimum capital stock tax are those operating, for a shorter or longer time, in the no-profit margin. With the qualifications noted below, a tax borne by marginal firms is shifted. To the extent that these marginal firms shift their capital stock minimum taxes, the supramarginal firms paying on their income may be able to shift their levies.

Capital stock corporate franchise and privilege taxes constitute special discriminations against a particular form of business enterprise. Unincorporated enterprises are not subject to these taxes. Even where certain corporation taxes are intended to be substitutes for taxes to which unincorporated business concerns are subject,

²⁵ National Industrial Conference Board, *The Shifting and Effects of the Federal Corporation Income Tax* (New York, 1928), Vol. I, pp. 137-138, 152.

the burden of the special corporation tax is nearly always much heavier than that of the tax for which it is substituted. Because of the inequality of the tax burden which they impose, the capital stock corporation franchise and privilege taxes are for the most part nonshiftable. In those lines of business activity where the corporate form is so prevalent that unincorporated enterprises are a negligible competitive factor, capital stock taxes may be shifted to some extent.

No general rules can be laid down on the business license taxes found in such great profusion in the southern states. Many of these taxes are fixed taxes which give a large concern an advantage over a smaller concern paying the same amount of tax. Having this advantage, the larger firms sometimes add to the prices of their commodities and services somewhat more than the amount of tax they pay. Also, they are sometimes able to drive their smaller, less prosperous competitors out of business and gain the entire market for themselves.

Payroll taxes present an interesting problem in incidence. Obviously the six per cent tax that employers will be paying by 1949 could not be absorbed by many of them without completely wiping out their margin of net profit. The tax affects marginal producers, and so must be shifted—either forward by increasing prices or backward by decreasing wages. The natural inclination of employers in this matter is to shift the tax backward through wages. Where labor is not organized to resist such action, some backward shifting of this sort may have occurred—if not by specific wage cuts, then by resistance to promotions and wage increases. Even in lines where labor is strongly organized, employers may have been induced by thought of the tax and the expenditure to which it is devoted to oppose more vigorously than otherwise the unions' demands for wage increases. But forward shifting has also occurred on a major scale—probably to a greater degree than backward shifting.²⁶ The effect of such forward shifting would not be uniform on all prices,

²⁶ For an argument that the major incidence of a payroll tax is on wages, see James K. Hall, "Incidence of Federal Social Security Pay Roll Taxes," *Quarterly Journal of Economics*, November 1938, Vol. LIII, pp. 38-63.

because some commodities and services involve greater labor costs, and hence greater payroll tax costs than others. There has probably been a subtle readjustment of all price schedules during the past few years to accommodate this partial forward shifting of payroll taxes. In the course of these readjustments, incidentally, a further powerful impetus has been given to labor-saving mechanization; the payroll tax has added six per cent to the previous labor costs of industries, and has shifted accordingly the "margin of mechanization indifference."

The possibility of shifting business taxes is affected by the circumstance that such taxes are levied by state and local governments whose jurisdictions are geographically limited, while the markets in which many manufacturers and some wholesale merchants compete are interstate. As was indicated in Chapter XI,²⁷ variations in the business tax burdens imposed by different states result in inequalities which may bar the complete shifting of taxes levied by the heavier-taxing states, when the industries of both high-taxing and low-taxing states compete in a common market. It should be noted in this connection that inequality in the general burdens of the business taxes of two states does not in itself cause the business taxes of the heavier-taxing state to be nonshiftable. The impossibility of shifting a business tax results from the inequality of tax burdens imposed upon particular enterprises located in different states but directly in competition with each other—the inequality in tax burdens between the steel corporation taxed under property taxes and a capital stock tax in State *A* and the steel corporation taxed under property taxes and an income tax in State *B*, the inequality in tax burdens between the shoe manufacturer taxed under a turnover tax in State *C* and the one taxed under a corporate excess tax in State *D*.

State and local taxes on public service enterprises, irrespective of the character of the taxes, are quite generally shifted. State public service commissions and the Interstate Commerce Commission view these taxes as costs to be fully allowed in setting rates

²⁷ See p. 259 of this volume.

which will yield a reasonable return over and above all costs of operation. An increase of state and local taxes on public service enterprises is considered an increase of operating costs to be compensated by increased rates. Since public service enterprise taxes are generally shifted, state legislatures sometimes regard them as a means of levying indirect taxes which will eventually rest on the general public but which will arouse little popular interest.

But two obstacles stand in the way of smooth and immediate shifting of all state and local public service enterprise taxes. Changes in tax burdens on public service enterprises occur at frequent intervals, while rate revision is an infrequent procedure. Consequently, there is a lag between a change in the state and local tax burden on a public service enterprise, and its shift to the consumers of the enterprise's services by a modification of its rate schedule. Furthermore, the rate schedules of some public service enterprises are of such nature that a small change in tax burden cannot be compensated by a corresponding modification of rate schedules. If the taxes of a streetcar company operating on a nickel fare amount to one-tenth of its current costs, a doubling of its taxes cannot be translated into a proportionate increase of the fare. The fare must be either increased by a full cent, which would increase the gross revenue by more than the amount of tax increase, or the fare must remain unchanged, in which case the tax is not shifted.

Although in general a net income tax on business enterprises is difficult to shift, there is a strong probability that much of the federal corporation income tax applying to public service corporations is shifted, since many regulatory commissions treat it as an operating cost to be covered by the corporations' charges. Inquiry on this subject yielded the following conclusions:

The Interstate Commerce Commission has expressly declared its intention to so deal with the federal income tax in its regulation of interstate rates that the tax shall be shifted except for the personal normal tax allowance (an allowance for the circumstance that the dividends on stock of public service corporations are not subject to the normal tax of the federal personal income tax). The regulatory commissions of some of the industrial

states, accounting for a considerable proportion of intrastate public service values, by their procedure or, more rarely, by specific statement, indicate their belief that the tax should not be shifted. The commissions of several other important industrial states, on the contrary, believe that public service rates should be so adjusted as to permit the corporations to shift the federal income tax in order to encourage investment in public service enterprises. Finally, among the group of states that are indefinite as to their attitude towards this issue, it is probable that some either deliberately or inadvertently permit the corporation income tax on their public service corporations to be shifted. . . . The evidence available leads to the general conclusion that a considerable part of the federal corporation income tax on public service corporations is shifted. It is equally clear, however, that, as a result of the policy and procedure of many regulatory commissions, some part if not all of the tax is borne by some of the companies themselves, reducing the profits they would otherwise earn.²⁸

Distributive considerations

The distributive aspects of business taxes are confused since such taxes are sometimes shifted to consumers of the taxed concerns' commodities and services, and are sometimes borne by the taxed concerns as reductions of net profits. When a business tax is shifted, its ultimate burden, unless the tax is limited to luxury lines, is likely to be regressive, to bear more heavily on the poorer classes than on the richer classes. When a business tax cannot be shifted, its ultimate burden is likely to embody elements of progression, since the owners of business enterprises, whether personal concerns, partnerships, or incorporated enterprises, are usually found among the more well-to-do classes of the population. Sharp distinction should be drawn between the shiftable and the nonshiftable taxes in considering the distributive aspects of business taxes.

Shifted business taxes are not to be condemned merely because their ultimate social burden is regressive. Their effect may be counterbalanced by progressive income and death taxes, and the two systems of taxes in combination may result in a satisfactory graduation of social tax burdens.

²⁸ National Industrial Conference Board, *op. cit.*, Vol. II, pp. 87-88, 89.

acts of incorporation or "doing business in the state as a corporation" are "privileges" granted by the state government for which special payment should be made. Some writers have gone further and argue that any sort of business activity can be carried on only with the consent of the State and hence is a "privilege" which may be taxed. Public service enterprises using streets and highways for their tracks, wires, and pipes are considered to enjoy "special" privileges or franchises which justify the special taxes imposed.

But all these "justifications" of business taxation are after-the-fact rationalizations. The fundamental reason for business taxation is its convenience as a method of obtaining substantial revenue. Here, as in other fields of taxation, principles of "tax justice" are humble handmaidens to fiscal expediency.

CHAPTER XXII

Commodity Taxes and Related Excises

COMMODITY taxes may be classified under three headings—customs duties, specific commodity taxes, and general sales taxes.¹ Customs duties, an exclusive prerogative of the federal government, are moderately important from a revenue viewpoint. During the 1920's and early 1930's, customs revenues varied between \$250,000,000 and \$600,000,000 a year—from one-tenth to one-sixth of the total federal tax revenue—according to foreign trade conditions; since 1933 they have varied between \$300,000,000 and \$500,000,000, but their proportion of total federal revenues has fallen to a trifling fraction.

As stated earlier,² specific commodity taxes are sometimes imposed as “sumptuary” levies—regulatory levies intended to discourage the purchase and consumption of certain commodities deemed socially harmful by forcing up their prices. Federal liquor and tobacco excises, federal and state taxes on oleomargarine, and the state tobacco and liquor taxes are of this character. But revenue considerations hold primary place even in sumptuary taxes, and many commodity levies have no sumptuary intent whatsoever. General sales taxes are imposed exclusively for revenue purposes.

Ever since the Civil War, specific commodity taxes have been an important element of the federal tax system. During World War I and again after 1932 the range of federal commodity taxation was broadened, with a corresponding enhancement of their contribution to federal revenues; recently they have yielded around \$1,800,000,000 annually. Although the states have made less use of specific commodity taxes, they have recently turned extensively to general sales

¹ Specific commodity taxes and general sales taxes are more frequently levied as license taxes on manufacturing or mercantile enterprises than as excises on the commodities themselves. In this chapter a business tax *measured by* the quantity or value of commodities produced and sold is considered a commodity tax.

² See p. 275 of this volume.

taxes In 1940, state general sales taxes produced nearly \$500,000,000, their liquor taxes yielded around \$250,000,000, and their tobacco products taxes nearly \$100,000,000.

Closely allied in economic character to commodity taxes are the federal and state levies imposed on the payment for certain services. Amusement ticket taxes and club dues taxes are the most important current examples of service taxation. Taxes on financial transfers, such as stock issue and transfer taxes, bank check taxes, and mortgage recording taxes may also be conveniently studied in connection with commodity and service taxes, since such transfers may be viewed as a form of service.

CUSTOMS DUTIES

A customs duty is a tax, per value or per quantity and quality unit, on commodities imported into a governmental area. Prior to the nineteenth century, local governments of all sorts commonly levied import duties under the name of transit tax or *octroi*. For the past century and a half, however, in the United States and most other countries, import or customs duties have been reserved exclusively to the national government. The American federal constitution specifically forbids state and local governments to impose import duties.

One or both of two motives may dictate the levy of customs duties. To raise a large revenue with a minimum of administrative cost, moderate rates may be imposed on mass-consumption commodities not produced in the taxing country. Or high rates may be set on imported commodities competing with the same or similar articles produced in the taxing country, with intent so to raise the selling price of the imported items that their competition with the domestic products will be weakened. The first type of customs duty is popularly referred to as a "tariff for revenue only," the second as a "protective tariff." From the levy of our first national customs duty in 1789, the regulatory "protective" aspect of the tax has been of greater concern to Congress and to writers on economics than its revenue aspect.

History

"Protection" was specifically stated as a purpose of the Tariff Act of 1789. Its preamble read:

Whereas it is necessary for the support of the government, for the discharge of the debts of the United States, and the encouragement and protection of manufactures that duties be laid. . . .

A 5 per cent tax was imposed on all unenumerated imports, somewhat higher duties on specified luxury articles, and special high rates on hemp, cordage, nails, ironware and glass, with intent to encourage domestic manufacture of these particular articles. The protective principle, openly acknowledged as the fundamental policy of the Tariff of 1816, was applied with increasing force in the Tariffs of 1824, 1828, and 1832, and was only partly surrendered in the Compromise Tariff of 1833. Moderate protection was established in the Tariffs of 1842 and 1846 with a general 30 per cent rate on manufactured items competing with domestic products.

For revenue purposes, tariff rates were set at a high level during the Civil War. In the twenty-five years following the Civil War, the political disorganization of the widespread "free trade" sentiment permitted the "protectionist" interests to block any substantial reduction of the Civil War tariffs and at the same time consolidate their position in Congress. By 1890 the protectionists were able to work their full will in the McKinley Tariff. Duties were placed on practically every class of import which competed with articles manufactured in the United States, and in some cases rates were high enough practically to prohibit importation. On foreign items which did not offer serious competition to American producers the duties were reduced or abolished.

Since 1890 customs duties have undergone six major revisions—the Wilson-Gorman Tariff of 1894, the Dingley Tariff of 1897, the Payne-Aldrich Tariff of 1909, the Underwood Tariff of 1913, the related Emergency Tariff of 1921 and Fordney-McCumber Tariff of 1922, and finally the Hawley-Smoot Tariff of 1930. Not one of these acts made so much as a gesture in the direction of "free trade,"

and the Underwood Tariff of 1913, the only one of the six to accomplish any substantial reduction of customs rates from the pre-existing level, avowed as its purpose the protection of "legitimate industry." The Tariff Acts of 1922 and 1930 openly specified protection rather than revenue as their purpose, and provided elaborate machinery for adjusting rates to a "true" or "scientific" protection basis—the equalization of differences between foreign and domestic costs of production for competing commodities. These two acts further enlarged the scope of tariff protection by extending it to agricultural products.

Except in extreme cases, a protective customs duty does not prohibit, but merely reduces, the importation of foreign goods, and for that reason American protective duties have generally been a lucrative source of federal revenue. Prior to the Civil War, they were the main, and at times the only, source of tax revenue for the federal government. Thereafter, until 1913, they provided somewhat over half the total federal tax revenue. During the "normal" 1920's their annual yield averaged well over \$500,000,000. Even with a lower level of foreign trade during the 1930's, they have produced from \$250,000,000 to \$380,000,000 a year.

Economics of the protective tariff

Protective customs duties are an instance of a commodity tax imposed on one of two competing commodities³ With such a tax, the initial effect is to increase the price of the taxed commodity—in this case, the imported article—thus persuading purchasers to turn to the corresponding article of domestic manufacture. The pressure of increased demand on the existing supply of the domestic article forces up its price also. According to the elasticity of the demand for the article in question, the prices both of the imported item and of its domestic competitor are initially increased by somewhat less than the amount of the tax.

Higher prices obtainable for domestic articles protected by a customs duty result at first in higher profits for the protected domestic industries and hence encourage them to expand their production.

³ The shifting and incidence of such a tax is discussed in detail on p. 237 of this volume

If a protected industry is in its "infant" stage, economies of large-scale production and distribution may result from its growth, so that it proves to be a "decreasing-cost" industry. Eventually the combination of lower production and distribution costs and of competition among domestic producers may force the price of the domestic commodity down to that paid for the imported article before the customs duty was imposed, or the new price may fall even below this earlier level. Meanwhile the market for the article in question is entirely taken over by the domestic producers. Results are different if the protected industry is not well adapted to development within the taxing country, or if it has already reached a mature development and must accomplish further expansion on an increasing-cost basis. Then the customs duty leads to a new price higher than the old, though not necessarily by the full amount of the tax, and the higher price applies both to the taxed import and the untaxed domestic article. In the course of cost and price readjustments, domestic producers are able to take over more or less of the market previously enjoyed by the imported item.

Proponents of protective customs duties have so overworked the "infant industries" argument, based on the economic reasoning indicated above, that it has become a controversial liability rather than an asset. But they have several arguments besides this one. With respect to the protection of maladapted or increasing-cost industries, they claim that the added cost to consumers is counterbalanced by an expansion of domestic industry, with consequent increased employment, increased payrolls, increased purchase of materials, and increased producers' profits—all elements of national prosperity. They insist that the lower costs of foreign production, which would enable foreign goods to undersell American goods were there no protective tariff, result from lower foreign wage standards; apparent protection of American manufacturers is therefore protection of the wage scales paid by these manufacturers. Finally, they argue that many of the "maladapted" industries fostered by the protective tariff would be vital to national self-sufficiency in time of war, and must be established and fostered irrespective of cost to consumers.

Opponents of tariff "protection" base their position primarily on

the doctrine of "comparative national advantages"—the principle that each nation profits most by producing and exporting those goods and services for which its economic resources give it peculiar advantages and by importing items produced at special advantage by other countries. A protective tariff nullifies such "comparative advantages," with the result, in the words of Adam Smith, that

the industry of the country, therefore, is thus turned away from a more, to a less advantageous employment, and the exchangeable value of its annual produce, instead of being increased, according to the intention of the lawgiver, must necessarily be diminished . . .⁴

Another point made by the antiprotectionists is that the exports of the United States must be eventually paid for by imports from abroad; to the extent, therefore, that imports are checked by a protective tariff, production for export is likewise checked. Moreover, since high tariffs breed retaliatory high tariffs, whatever American industry gains from the protection of its domestic market it loses directly through suppression of its export market; enactment of the 1930 tariff, for example, led to an avalanche of foreign retaliatory tariffs which seriously cut American export trade. And according to the antiprotectionists, the disequilibrium of the American balance of international payments during the 1920's, which contributed so much to world-wide financial collapse after 1929, was largely the fault of the repression of American imports by the tariff.

Distributive considerations in general count against protective tariffs. Although high rates on luxury imports rest upon the better-to-do purchasers who have ample "ability" to bear the special burden, the greater part of the customs revenue is derived from rates on items entering directly or indirectly into mass consumption. Furthermore, and even more important, to the extent that rates on these items are truly "protective," prices of corresponding domestic items are raised. Thus the cost of living of the poorer as well as of the richer classes is increased, part of the increase going to the gov-

⁴ Adam Smith, *An Inquiry into the Nature and Causes of the Wealth of Nations*, Bk IV, Ch 3.

ernment as tax revenue, if the duty is not prohibitive, and part going to domestic manufacturers and workers in the protected industries as higher profits and wages.

Rate structure

Customs rates take two forms—specific and ad valorem. A specific duty is one levied according to the weight, bulk, length, or some other unity of measurement for the commodity; imported lychee nuts, for example, are taxed $2\frac{1}{2}$ cents per pound. An ad valorem rate is levied as a percentage of the commodity's value; imported oboes are taxed 40 per cent on their value.

Specific customs rates tend to place a relatively heavier burden on the coarser and cheaper grades of goods than on the better grades, since the rates bear no relation to value. Inasmuch as the coarser and cheaper grades are bought chiefly by the poorer classes, a specific customs rate has a markedly regressive distributive effect. Further, the burden of specific rates varies as price levels change. In a period of rising prices, an unchanged schedule of specific duties results in a constant lowering of tax rates as measured by values. Similarly, in a period of falling prices there is a tendency towards a growing tax burden as measured by the value of the imported articles. Offsetting these disadvantages of specific customs rates is their great virtue—the relative ease of their assessment. And manufacturers seeking protection like them because prohibitive levies on cheap goods can be concealed by rates which do not appear prohibitive when related only to more expensive grades.

An ad valorem rate is more equitable in its ultimate incidence, since it does not produce an internal discrimination against coarser and cheaper grades of goods, and hence does not result in a direct regressive burden. Moreover, the burden of the tax does not vary with price changes. But great administrative difficulties are entailed. Choice must be made between several trade-custom prices—the foreign manufacturer's price, the f.o.b. price, the c.i.f. price, or the American selling price. Arbitrary values must be established for consigned goods. Price changes on thousands of taxed items must constantly be taken into account.

American customs duties follow no consistent policy as to form of rates. For some items the rates are specific, for others ad valorem. Still others are subject to supplementary ad valorem rates superimposed upon basic specific rates. In some cases alternative rates are established, the higher at any time being applied. And many examples may be found of specific rates graduated according to the value of the import.

When a raw material or semimanufactured import is taxed, an extra cost element is added to the price of all manufactured articles produced from the imported item or similar domestic items. If American producers are to be placed on equal footing with their foreign competitors, imports of the manufactured article must be subjected to a "compensatory" duty equal to the amount of the raw material duty entering into the cost of the finished article. If American producers are to be "protected," the manufactured imports must be taxed over and above the "compensatory" rate. "Compensatory" tariffs must be imposed on almost all imports competing with domestic articles subjected to internal excises; the Agricultural Adjustment Act of 1933, for example, made specific provision for compensatory customs duties to balance the processing taxes imposed by the act.

Rate determination

Economic reason and statesmanship have no part in the writing of a tariff act. To a greater extent than in any other field of taxation, customs rates are determined by pressure group tactics applied to House and Senate committees, to individual members of Congress, and to the President himself.⁵ Tariff Commission findings are ignored unless they make a case for higher rates, and when they are utilized are simply one more item of propaganda. The schedules ultimately embodied in law are not a system, but a hodgepodge of logrolled "protections" for the industries whose lobbies are powerful enough or skillful enough to win their demands. The "dutiable list" of the 1930 Tariff Act contains 1559 paragraphs, bewildering in the complexity of their specifications and rate sched-

⁵ See William J. Shultz, *Your Taxes* (Doubleday Doran, New York, 1938), Ch. VI

ules, with little interrelationship other than that of alphabetical sequence. Any pretense at the time the law was passed that the levies actually "equalized" foreign and domestic costs of production was a fiction of the propagandists. Some rates overshot the mark, others fell short, and changes in domestic and foreign costs of production and prices since the passage of the act make even the pretense of "equalization" meaningless.

The customs rates established by the 1922 and 1930 laws are called "flexible" because the President is empowered, after investigation by the Tariff Commission, to raise or lower any rate by 50 per cent, to modify classifications, and to change the basis of ad valorem rates from the foreign selling price to the American selling price, when in his opinion such action is necessary to "equalize" foreign and domestic costs of production. Thus at his discretion, a President might remake the entire rate structure of the tariff system, raising protection to prohibitive levels or practically wiping it out. Actually, the four Presidents who have had this power at their command have made sparing use of it; only a few casual rate increases have resulted from the "flexible" clause.

Retaliation and reciprocity

From earliest times American customs duties have been used as a club to coerce foreign countries into according nondiscriminatory treatment to American trade or American goods. An act of 1818 imposed a special set of retaliatory duties to be applied to imports from countries discriminating against the United States; the President was empowered to suspend these rates when the discrimination was ended. Such retaliatory levies were a feature of the American customs system through the nineteenth century. The McKinley Tariff of 1890 had such a schedule under the misleading name of "reciprocity clause." Retaliatory duties were dropped in the Act of 1894, but restored in 1897. In the Act of 1909 the principle was applied more broadly—a double schedule of rates was established for most items, the higher to be applied at the President's discretion to imports from countries which discriminated

against the United States. Under the 1922 and 1930 acts, the President may retaliate against discrimination by raising rates up to 50 per cent, and can impose "countervailing" duties against imports of countries which foster "dumping" by export bounties.

A more conciliatory approach to the problem of international trade relations was made in the Dingley Tariff of 1897. Besides its retaliatory schedule, it had its "argol" list—a set of duties on specified imports which might be lowered by the President upon negotiation of trade arrangements with other countries. And a clause of this law, never utilized, authorized the President to negotiate five-year reciprocity treaties with other countries which might include a lowering of existing American customs rates. This reciprocity idea was dropped in the Tariff of 1909, and not revived until twenty-five years later when the Trade Agreements Act of 1934 again authorized reciprocal tariff-lowering trade treaties. Prior to the outbreak of World War II in 1939, which changed completely the complexion of America's foreign trade, seventeen such agreements had been negotiated, some of them making serious breaches in America's protective tariff wall.

FEDERAL COMMODITY, SERVICE, AND TRANSFER EXCISES ⁶

Because of the constitutional requirement that direct taxes be apportioned, the federal government may not levy a tax on any class of commodities as property unless it provides some method of apportioning the tax among the states according to population. But the federal government has ample power to levy taxes on the manufacture or on the sale of commodities, such taxes being construed as excises on acts rather than as direct taxes on property.⁷ A federal commodity tax may not, however, be extended to goods intended for sale to foreign customers, since as to such goods it is construed as a constitutionally forbidden export tax.⁸

⁶ Exclusive of the gasoline tax, which is discussed in the next chapter.

⁷ *Patton v Brady*, 184 U. S. (1902) 638.

⁸ *Spalding & Brothers v. Edwards*, 262 U. S. (1923) 66.

History

A federal liquor excise was imposed in 1791 and its revenue earmarked to payment of the interest and the principal of the federal debt. Later statutes levied special taxes on carriages, on the sale of certain liquors, on snuff, on sugar, on auction sales, and on various legal instruments. Opposition to these early federal excises was strong, and the entire system was swept away in 1802. War needs led to the reimposition of a series of similar federal commodity and transaction taxes in 1813 which lasted only until 1817. No other federal commodity excises were levied until the Civil War period.

The present system of federal commodity excises dates from the Civil War. In 1862, the pressing need for Civil War revenue led Congress to impose a combination of business and commodity taxes, of which the most important were those on spirituous liquors and tobaccos. Subsequent war legislation imposed a gross receipts tax upon manufacturers which in its practical application was a general sales tax on all manufactured commodities. Its general level, at first 3 per cent, was subsequently increased to 5 per cent. The war over, certain of the federal commodity taxes were reduced or abolished, until by the 1880's only the excises on spirits, fermented liquors, and tobacco were left. An oleomargarine tax was added to the group in 1887.

Tobacco and fermented liquor taxes during the Spanish War were doubled. Telegraph and telephone messages were taxed, and stamp duties were placed on various legal documents, including corporate securities, and on patent medicines and chewing gum. But in general the government turned to special business and occupation taxes rather than to additional commodity taxes. World War I revenue acts, however, expanded considerably the field of federal commodity and service taxation. Rates on tobacco products and liquors were raised. A moderate soft drinks tax was imposed. Excises were directed at a group of semiluxury and luxury items—automobiles, musical instruments, jewelry, cosmetics, chewing gum, sporting goods, games, and yachts. Substantial taxes were imposed

on freight and passenger transportation, and on telegraph and telephone messages. Stock transfers were taxed and a moderate stamp duty laid on financial instruments. During fiscal years 1919 and 1920, these taxes produced over \$1,000,000,000 annually.

Accepted without opposition in the war years, these taxes were afterwards dubbed "nuisance taxes" and became extremely unpopular. Tax revisions in 1921, 1924, 1926, and 1928 reduced or eliminated many of them. The major portion of the tax on spirits had been lost, of course, with the advent of Prohibition, and the tax on fermented liquors had vanished altogether. By 1930 the tobacco excise, with an annual yield close to half a billion dollars, was the only important federal commodity or service excise remaining.

The shrinkage of other federal revenues as a consequence of depression inspired a drive in 1932 for a federal general sales tax. Popular opposition killed this proposal, and instead Congress restored most of the wartime commodity and service excises. A newcomer to the federal excise fold was a $3\frac{1}{3}$ per cent tax on electricity consumption. Repeal of the Prohibition amendment permitted the restoration of liquor taxation. The Agricultural Adjustment Act of 1933 and later supplementary crop control acts authorized the imposition of so-called "processing" taxes—excises imposed at some focal processing point on each controlled agricultural product, the revenue from which was utilized for farmers' bounties; these taxes were declared unconstitutional in 1936 because of the earmarking of their revenues.⁹ A new impetus was imparted to federal commodity and service excise taxation by the need for "defense" revenue after 1940; the revenue acts of 1940 and 1941 increased the rates of existing excises, and added a number of new ones.

Current status

The several score levies and rates embodied in the present system of federal commodity, service, and transfer excises can be grouped

⁹ *U S. v Butler*, 297 U S (1936) 1.

into a much smaller number of categories according to their basic characters and purposes.

First and foremost from a revenue viewpoint are the liquor excises—\$4.00 per gallon on distilled spirits, \$6.00 per barrel on fermented liquors, and from 8 to 65 cents per gallon on wines. Tobacco taxes, almost the fiscal equal of the liquor excises, also embody different rates for different items. Cigars pay from 75 cents to \$13.50 a thousand, according to weight and retail price; cigarettes pay from \$3.25 to \$7.20 per thousand according to weight; smoking tobacco pays 18 cents a pound; and there are rates for snuff and cigarette papers.

A third set of rates applies to luxuries and semiluxuries. Club dues, amusement admissions, radios, musical instruments, cameras, toilet preparations, sporting goods, and firearms are taxed at 10 or 11 per cent. Playing cards are taxed 13 cents per deck. Related to these luxury excises are the "control" excises imposed by the Revenue Act of 1941 for the purpose of reducing consumption of articles whose production competes with the defense effort; among the articles subjected to such "control" taxation are automobiles and automobile parts, mechanical refrigerators, electrical appliances, and rubber goods.

Communication and transportation services compose a fourth subject of federal taxation. Telephone toll calls, telegraph and cable messages, foreign travel tickets, and oil pipe line charges all have specific or ad valorem rates. The $3\frac{1}{3}$ per cent tax on electricity charges may be counted in with these other service excises. Still another category includes the transfer taxes, moderate in rate but substantial in yield, which are imposed on sales on the produce exchanges, on bond and stock transfers, and on other conveyances.

A final group of federal commodity taxes is strictly regulatory in character and produces little or no revenue. Sale of a machine gun is taxed \$200. Opium is taxed one cent a pound when sold for medicinal purposes, \$300 a pound otherwise. Marihuana sales are taxed \$100 per ounce. The oleomargarine tax of 10 cents per pound and the vegetable oils taxes of 3 and 5 cents per pound may

also be considered primarily regulatory in intent, since their purpose is rather to discourage production of competitive substitutes for butter than to produce revenue.

STATE SPECIFIC COMMODITY AND SERVICE TAXES¹⁰

Commodity taxes are something of an innovation in state tax systems. Prior to the 1920's, some of the southern states based occasional special license taxes on value or amount of production or sales. And some of the state liquor taxes were based on sales or gross income, so that in their economic effects they might be considered commodity taxes. Such taxes, however, were exceptional.

In 1919 Alabama imposed a tax on carbonic acid used in soft drinks. Connecticut levied an admissions tax and Iowa a cigarette tax in 1921. These three laws marked out the main fields of commodity and service taxation exploited by the states during the next dozen years. When the Prohibition amendment was repealed in 1933, those states which authorized the production and consumption of alcoholic beverages were able to revive liquor taxation.

Constitutional considerations

In states whose constitutions have no strict uniformity requirement, commodity taxes might conceivably be levied as property taxes. Instead, the states have chosen to levy their commodity taxes as excises on the act of manufacture or sale. Unlike similar federal levies, such state commodity taxes are subject to a constitutional limitation. A state commodity tax applying to merchants may not cover the sales they make to customers outside the taxing state, as otherwise it would contravene the interstate commerce limitation.¹¹ It should be noted, however, that a tax on the output of manufacturers or of mining companies is not construed as a tax on the sales of these companies but as an excise on the acts of manufacturing or of mining, measured by the sales value of the

¹⁰ Exclusive of gasoline taxes, which are studied in the next chapter.

¹¹ *Crew Levick Co v Pennsylvania*, 245 U. S. (1917) 292; *Chapman v International Shoe Co.*, 276 U. S. (1928) 635.

manufactured or mined product. The interstate commerce limitation does not apply to such taxes, on the theory that they do not involve any act of commerce, interstate or otherwise.¹²

Liquor and beverage taxes

Every state that does not prohibit alcoholic beverages imposes lump sum license taxes on manufacturers, wholesalers, retailers, and dispensers. These were studied in an earlier chapter.¹³ But in addition to these license taxes, practically every nonprohibition state imposes so-called "gallonge" taxes on the volume of various alcoholic drinks produced or sold within the state.

Most of the liquor "gallonge" taxes are stamp or crown duties;¹⁴ the remainder are collected on the basis of monthly reports made on the taxpayers. Some states collect the tax from retailers, others from manufacturers and importers. The choice is solely a matter of administrative convenience, since under any and all circumstances the tax is shifted along until it is embodied in the price charged to the consumer. Rate schedules of these gallonge taxes vary from state to state, but one element of uniformity is found in all—beer is taxed at the lowest rate, wines at intermediate rates, and distilled spirits at the highest rate. The schedule of the New Jersey tax, chosen at random, is as follows:

| | |
|--|-------------------|
| beer | 3½ cents a gallon |
| still wines not containing more than 21% alcohol | 10 cents a gallon |
| still wines containing more than 21% alcohol | 25 cents a gallon |
| sparkling wines | 40 cents a gallon |
| liquor | \$1 a gallon |

State liquor taxes produced over \$200,000,000 in 1940. Soft drink taxes in the same year yielded \$3,300,000.

¹² *American Manufacturing Co v St Louis*, 250 U. S. (1919) 459; *Heisler v Thomas Colliery Co*, 260 U S (1922) 245, *Oliver Iron Co v. Lord*, 262 U S (1923) 172, *Lacoste v Department of Conservation*, 263 U. S (1924) 545, *Hope Natural Gas Co. v Hall*, 274 U S (1927) 284

¹³ See p 525 of this volume

¹⁴ Stamp and crown tax administration is explained on pp 566-567 of this volume.

Tobacco products taxes

Fifteen states now tax the sale of cigarettes, two the sale of cigars and cigarettes, and eight the sale of all tobacco products. As in the case of liquor taxes, tobacco products taxes are collected by the sale of stamps which must be affixed to the packages. Also similar to the liquor taxes, the responsibility of purchasing and affixing the stamps is laid sometimes on the manufacturer and wholesaler, sometimes on the retailer. Rates for the cigarette taxes are commonly 1 or 1½ cents for ten, are sometimes graduated by the weight of the cigarettes. Cigar tax rates are usually graduated according to weight of the cigars.

Yield of state tobacco products taxes in 1940 was close to \$100,000,000.

Other state commodity and service taxes

Fifteen states tax soft drinks. In most cases the tax is imposed on the malt extract, or syrup, or carbonic acid gas used to make the drinks. In a few instances, the levy is on the retail sale of the drinks.

Sixteen states tax admissions to all public amusements. With but one exception the tax is collected on a gross receipts basis; Connecticut has a theatre tax with a daily charge per theatre graduated by seating capacity. Rates range from one-half per cent in West Virginia to 10 per cent in Mississippi and Texas.

Thirteen states that do not tax theatre or motion picture admissions, and several others that do, impose special taxes on admissions to prize fights, athletic exhibitions, or horse races. Rates for these sumptuary taxes are generally higher than for the theatre and motion picture taxes; 10, 15, and 20 per cent rates are common.

STATE SECURITY TRANSFER TAXES

Security transfer taxes are worth levying only in those states which contain a major financial center wherein purchases and sales of securities occur in large volume. On this consideration, New York, Pennsylvania, Massachusetts, Illinois, and California would

be the states wherein security transfer taxes might be expected, yet only the first three impose such taxes. Illinois and California have never imposed any. Florida and South Carolina levy security transfer taxes although the revenue potentialities are too slight to be of any importance.

The Florida and South Carolina taxes, like the federal tax, apply to both stocks and bonds; the other three state taxes apply only to stock transfers. In all five cases, the tax obligation rests upon the seller, and arises whether the transfer is privately negotiated between individuals or is handled by brokers; as a matter of practice, private transfers probably evade the tax in large part. Tax collection is effected by attaching revenue stamps to memos of sale.

New York's stock transfer tax is highly productive. In 1930, the year of greatest yield, the tax produced \$39,000,000; for 1940 the yield was \$19,000,000. Other states obtain only small amounts from their stock transfer taxes.

STATE GENERAL SALES TAXES ¹⁵

In 1821 Pennsylvania imposed a merchants' license tax measured by gross sales which, with some justice, might be called the first American state sales tax. The Virginia merchants' license tax of 1887, measured by purchases, and the Delaware merchants' license tax of 1906, another purchases tax, could also be considered sales taxes of a sort. But West Virginia's gross sales tax of 1921 truly initiated the state sales tax movement. This law imposed a one-tenth per cent rate on sales of extracted products, a one-third per cent rate on the "spread" of wholesalers, and a two-tenths per cent rate on sales by manufacturers and retailers and on personal and utility services; all taxpayers were allowed a \$10,000 exemption.

No other state sales taxes were enacted until 1929, when Georgia and Mississippi imposed gross sales taxes. Kentucky adopted a retail sales tax in 1930. In 1933 the sales tax movement became a stampede; twelve states in that year turned to "emergency" sales taxes to relieve the property tax burden and to provide funds for

¹⁵ The best recent study of the most common form of state general sales taxation is Neil H. Jacoby, *Retail Sales Taxation* (Commerce Clearing House, Chicago, 1939).

relief expenditures. Other states adopted the new tax form in each of the next four years. A small minority of these "emergency" sales taxes were repealed or allowed to lapse after one or two years, but for most the "emergency" which was the excuse for their levy has apparently taken on permanency, and the taxes remain. As of 1941, twenty-two states were levying sales taxes. The \$490,000,000 collected from this source in 1940 represented 12 per cent of total state tax revenue for the year. For individual states the proportion was much higher. Nearly 30 per cent of Washington's 1940 tax collections were from her general sales tax; California's general sales tax accounted for 28 per cent of that state's tax collections. Eight other states derived more than one-fifth of their revenue from this source. New York City, New Orleans, and some other cities also levy local retail sales taxes.

Scope

Economists specify five basic types of general sales tax—the retail sales tax; the manufacturers' excise, applying only to sales by manufacturers, the "gross sales" or "turnover" tax, applying to all sales of tangible commodities by manufacturers, wholesalers and retailers; the "gross income" tax, applying not only to sales of tangible commodities but also to gross income from services of all kinds; and the recently recommended tax on "value added by manufacture and distribution," which would be based on gross income from sales minus cost of purchases. The manufacturers' excise and the "value added" taxes are ill adapted to state levy, and no state employs these forms. As for the other three forms, not only are all employed by the states, but various intermediate forms are to be found. Among the state general sales taxes now in effect are retail sales taxes applying exclusively to commodity sales, some on retail commodity sales and certain personal and professional services, some on retail commodity sales and public utility services, some on retail and wholesale sales, some on "gross sales" or "turnover," and some on "gross income." This variation in the bases of the state sales taxes affects their productivity, a gross income tax

applying to all forms of business income, for example, has ten times the yield of a retail sales tax with the same rate.¹⁶

As with specific commodity taxes, constitutional considerations prevent the application of a state sales tax to wholesalers' and retailers' sales made to customers outside the taxing state. Sales to federal agencies are also beyond the reach of the states' taxing powers. Such sales are specifically or impliedly exempt under sales tax laws. In addition, to ease the burden on the poorer classes, several retail sales taxes exempt sales of foodstuffs. Rather frequently, sales to or by charitable institutions are exempt for social reasons. Administrative and social considerations prompt the exemption of housing, domestic service, and certain other categories of payments. Gasoline sales are sometimes exempted because they are subject to special gasoline taxes. And, finally, the agricultural lobbies have generally obtained the exemption of sales of farm produce.

An interesting supplement to retail sales taxes—the so-called “use tax”—has developed during the past few years. Retail sales taxes have had the weakness of encouraging large business consumers of certain products, and even occasional individual consumers, to make purchases in neighboring states levying no sales tax, and thus avoid the sales tax of their own state. To check this form of avoidance, eighteen states have imposed “use” taxes, at the same rates as their sales taxes, on commodities bought outside of the taxing state but brought within it and used there. Obviously a circumvention of the interstate commerce and “due process” limitations, these “use” taxes have nevertheless received the Supreme Court's approval.¹⁷

Rates and minimum exemptions

Most state retail sales taxes and those which apply to retail sales and services have a uniform 2 per cent rate; five have 3 per cent rates. The North Carolina and Pennsylvania taxes, which apply

¹⁶ Jacoby, *op cit*, pp. 17, 348

¹⁷ *Gregg v. Query*, 286 U. S. (1931) 472; *Nashville, Chattanooga & St. Louis Ry. Co. v. Wallace*, 288 U. S. (1932) 249, *Hennetord v. Silas Mason Co.*, 300 U. S. (1937) 577.

to both wholesalers and retailers, and the Connecticut unincorporated business tax and the Delaware business license tax, which apply in addition to manufacturers, have heavier rates for retailers than for manufacturers and wholesalers. Gross income taxes may have anywhere from two to nine rate categories; the West Virginia tax, for example, has the following schedule:

| | |
|--|-------|
| Wholesalers and jobbers | 0 15% |
| Manufacturers | 0 3 % |
| Retailers, bankers, amusements | 0.5 % |
| Coal mines, public service enterprises, electric railways, unclassified service occupations | 10 % |
| Limestone and sandstone quarries, timber companies | 15 % |
| Unclassified natural resources, contractors | 20 % |
| Oil wells, sand and gravel quarries, nondomestic electric current, natural gas wells (under \$5000 annually), toll bridges | 30 % |
| Domestic electric current, water companies | 40 % |
| Natural gas wells (over \$5000 annually) | 60 % |

Diversity of rates in a gross income tax is admission that such a tax is not uniformly shifted. It is a crude attempt to equalize the tax as among classes of enterprise. But unequal burdens as among firms within a class still persist.

Washington's gross income tax exempts retailers whose annual gross is under \$6000, and other firms with less than \$2400 annual gross. The Indiana gross income tax has exemptions of \$3000 and \$1000 respectively. And under the West Virginia gross income tax the first \$25 of calculated tax liability is exempt—which is equivalent to exempting the first \$16,600 of wholesalers' gross income, the first \$8300 of manufacturers' gross income, and the first \$5000 of retailers' gross income. Other state sales taxes either allow no minimum exemption, or a small administrative one.

ADMINISTRATION OF COMMODITY AND SALES TAXES

Proponents of commodity and sales taxes claim that the administration of such taxes is easier than for most other taxes. The claim is sound, but only from a relative viewpoint. Like any other

tax, commodity and sales taxes have their administrative problems. Good administration can make them successful revenue producers, lax or ill-advised administration can result in their failure.

Point of collection

Commodity tax administration is facilitated if the tax can be levied at a stage in the manufacturing and distributive process where transactions are concentrated in relatively few hands. In the case of the federal tobacco and liquor excises, this point of concentration is the process of manufacture. For some commodities, however, it is conceivable that the greatest concentration would be at the passage of the commodity through the hands of the wholesalers. A tax on such a commodity would be better charged to the wholesaler than to the manufacturer. Responsibility for the payment of state tobacco and liquor taxes is placed on local manufacturers for such part of their product as is sold within the taxing state; wholesale distributors are responsible for the tax on tobacco products or liquor brought in from other states.

Retail sales taxes may appear to impose tax liability at the point—retailing—where transactions are most widely diffused. But the states have little choice in the matter. A large fraction of the commodities consumed in each state comes from other states, and could not be reached by a state manufacturers' excise. And for most lines of distribution, wholesaler-retailer interrelationships overlap state lines, so that a domestic wholesalers' sales tax would not impose a universal or uniform tax on commodity consumption within the taxing state. Most consumption purchases of commodities can be reached only through retailers, and even then—as the development of the "use" tax indicates—the coverage is not complete.

Manner of collection

When a commodity is regularly sold in packages, the tax upon it can be levied in the form of a stamp tax. Persons charged with paying the tax directly to the government—usually the manufacturers, but sometimes the wholesalers and retailers—are required

to purchase revenue stamps and so attach them that the stamp is torn when the package is opened. Absence of a revenue stamp on a package advertises to all dealers and subsequent purchasers that the tax has been evaded. The offense is not easily concealed. Stamp taxes are generally acceptable to taxpayers since the mechanical procedure of affixing stamps is preferable to the complications of filling out detailed tax returns. Tax administrators approve of stamp taxes because their collection is accomplished by the sale of the revenue stamps to the taxpayers. The federal tobacco and playing card taxes are administered as stamp taxes. State tobacco products and liquor taxes are also usually levied as stamp taxes, the stamps being bought and affixed by the manufacturers and importing wholesalers; retailers are responsible for stamping any items that come to them unstamped through irregular channels of trade.¹⁸

For taxes on bottled beer and soft drinks, the "crown tax," a derivation of the stamp tax, is possible. The manufacturers of the crowns, or caps, that are pressed onto the bottles pay the beer or soft drinks tax in accordance with their sales of bottle caps to the beer and drink manufacturers. This tax is passed along in the price of the crowns to the manufacturers. They in turn embody the tax in the prices charged for their bottled wares.

General sales and gross income taxes apply to many commodities and services for which stamping is not practicable. They are necessarily assessed on the basis of monthly or quarterly returns submitted by the retailers or other concerns liable for the tax.¹⁹

Evasion

Where the payers of a particular tax are few in number, the administration can exercise a careful and detailed supervision impossible where the number of taxpayers is large. A general sales or turnover tax suffers from the circumstance that it must be collected in small amounts from a large number of taxpayers. The tax administration cannot enquire carefully into the accounts of

¹⁸ An exhibit of revenue stamps is presented in Appendix F, p. 846 of this volume.

¹⁹ A sample sales tax return is reproduced in Appendix F, p. 844 of this volume.

every little country cider mill and every corner candy store. Instead, it must trust to the honesty of the taxpayers and to such devices as the sample check, even though this involves the loss of 10 to 15 per cent of the tax revenue through evasion. The alternative—to allow an exemption which will eliminate the flood of returns from small dealers and small manufacturers—weakens the economic character of the tax.

A high tax invites evasion. The evasion of high liquor duties through "moonshining" is an old chapter in fiscal history. If, on the other hand, a tax is low, the risks of evasion outweigh its profits, and evasion is likely to be inconsiderable. It has therefore long been a canon of commodity taxation that a moderate tax on a commodity widely used in large quantities is preferable to a high tax upon a little-used commodity. Revenue necessities and a desire to subject luxury items to discriminatingly high rates frequently induce governments to ignore this canon, but rarely with success.

State commodity taxation is suffering to an increasing degree from so-called "interstate evasion." Fly-by-night tobacco and liquor firms, for example, establish themselves just across the border from a taxing state, and solicit "tax-free" orders from within it. Texas estimated several years ago that from \$500,000 to \$750,000 a year in cigarette taxes—from one-twelfth to one-eighth of its total tobacco tax collections—was lost through parcel post shipments into the state. "Use" taxes may apply to these transactions—seven states have special tobacco "use" taxes—but the administration of the taxing state cannot by itself reach the shippers to obtain records of their deliveries, and cannot trace the purchasers within its jurisdiction. Such evasion is being brought under control through interstate administrative cooperation. Seven southern states, for example, agreed in 1937 to exchange information on tobacco sales and shipments from one state into another, and to help enforce each other's laws.

ECONOMIC AND DISTRIBUTIVE CONSIDERATIONS

Commodity and sales taxes are good revenue producers. If the tax is general, or if the specific commodity taxed is widely con-

sumed, a low rate will produce a relatively large revenue. And commodity and sales tax yield, while not inelastic, is less subject to variation during the upswings and downswings of the business cycle than revenues from income or business taxes. Another big point in favor of commodity and sales taxes is that revenue begins to flow in immediately after their enactment, whereas for most other taxes there is a long lag between imposition and receipt of revenue. And finally, as already noted, commodity and sales taxes enjoy distinct administrative advantages.

Against all these favorable considerations stand the adverse economic and distributive effects of commodity and sales taxes, and most fiscal economists feel that these economic and distributive considerations outweigh all the favorable factors, leaving a net balance of argument against such taxes. Analysis of the incidence and social effects of commodity and sales taxes, therefore, assumes special importance.

Incidence and related economic effects

The incidence of taxes on particular commodities was studied in an earlier chapter,²⁰ and the conclusion was that such taxes are largely shifted to consumers by an increase in the price of the taxed commodity. The price increase need not be, and rarely is, exactly the amount of the tax. Commonly the price rises by more or less than the tax involved, depending upon the elasticity of demand for the commodity and the circumstances of its supply. Prices of joint products or competing commodities are also likely to be affected—lowered or raised—by the tax.

Theoretically a uniform retail sales tax should also shift to consumers, though not uniformly. Diminished consumer purchasing power resulting from the tax should unsettle the pre-existing distribution of consumption expenditures as among necessities, semiluxuries, and luxuries, reducing consumption demand for all items, but reducing demand for semiluxuries and luxuries more markedly than demand for necessities. Prices for all consumption items should be affected, according to the varied circumstances of their

²⁰ See pp 234-243 of this volume.

supply, but prices of semiluxuries and luxuries should be affected more than prices of necessities. Initially all prices should rise by the percentage of the tax, with subsequent readjustments up or down as reduction and shifting of demand makes its influence felt.

But, in this matter, experience does not tally completely with theory. Inquiry into actual results of state sales taxes indicates that merchants who initially pay a sales tax commonly meet considerable difficulty in adding the tax to the prices of the goods they sell. With respect to the shifting of these taxes, the authors of a searching analysis of American sales taxes came to the surprised conclusion that "economic friction must be a far more powerful factor than has hitherto been supposed."²¹ Under a 2 per cent sales tax, customers resent the addition of one cent to sales totals under fifty cents, and the addition of a second cent if the sales total is between fifty cents and a dollar. To appease their customers, small merchants, in particular, find themselves constrained to absorb at least part of the tax. Where large sales and substantial tax amounts are involved, customers try to bargain themselves out of the tax although they would not think of haggling over the net price. To the extent that merchants fail to shift a retail sales tax, it operates as a gross income tax on retail merchandising, unequal and frequently crushing in its burden.

Since it is the legislative intent that a retail sales tax be shifted, two "mandatory" shifting devices—the listed tax schedule and the tax token—have been authorized to overcome the frictions noted above. Under the listed tax schedule, a series of penny price ranges are established with a specified tax amount listed for each range. Thus under New York City's former 2 per cent retail sales tax, customers paid no tax on sales up to 12 cents, one cent tax on sales between 13 and 62 cents, 2 cents tax on sales between 63 cents and \$1.12, and so on up the scale. Elsewhere, tax tokens stamped either on metal or cardboard are issued in denominations of one-tenth cent and one-half cent. They are sold by storekeepers to customers, to be utilized for the express purpose of paying frac-

²¹ Robert M. Haig, Carl Shoup and associates, *The Sales Tax in the American States* (Columbia University Press, New York, 1934), p. 71.

tional-cent taxes on sales. A 1/10 cent token enables a customer to pay a 2 per cent sales tax on a five-cent sale. From all accounts, these "mandatory" devices make the shifting of retail sales taxes much more complete and uniform.

Even more obstacles are encountered in shifting manufacturers' excises, and gross sales and gross income taxes applying to manufacturers as well as merchandisers. As a commodity passes from one handler to another in the chain of production and distribution, the tax element to be incorporated into its ultimate price is pyramided. Some commodities pass through more hands than do others before they reach their ultimate consumers. There is wide divergence in the total taxes attached to various commodities, with consequent repercussions on demand, cost of production, and ultimate price readjustments. Furthermore, within a given commodity line, a manufacturers' excise, a gross sales tax, or a gross income tax discriminates against a series of single-process concerns, each of which in succession is taxed upon its sales, and in favor of a competing concern which engages in all productive and distributive processes connected with the manufacture and sale of its output and whose output as eventually sold bears only a single tax. The single-process concerns must absorb the difference between the pyramided taxes on their product and the single tax paid by their multi-process competitor. Attempts to alleviate this discrimination by "resale certificates," giving a reseller credit for earlier taxes paid on the commodity, complicate administration of the tax and add tremendously to "compliance" costs. And finally, a manufacturer may find himself unable to add a state gross sales or gross income tax to the prices of his output when he competes with manufacturers located in states which do not levy such taxes.

Distributive effects

To the extent that specific commodity taxes or general sales taxes are shifted, they constitute taxes on consumption. Added to this factor is the consideration that as compared to the richer classes, the poorer classes spend a larger proportion of net income on taxable items of consumption. Consequently, a tax which imposes a pro-

portional burden on consumption absorbs a larger proportion of the income of the poorer classes than of the richer classes—it is a regressive tax. A sales tax on all consumer expenditures would be sixteen to twenty times heavier for a family with a \$1000 income than for one with a \$1,000,000 income. If the tax were only on sales of tangible merchandise, it would be sixty times heavier for the \$1000 income family. This is the main basis for condemnation of general sales taxes.

Theoretically, commodity taxes may be so levied as to produce a progressive tax burden. If special taxes are levied on items—yachts, expensive makes of motor cars, jewelry, club dues, and so forth—purchased only or largely by the rich, the resulting burden will rest more heavily on the richer classes of the population than on the poorer and middle classes. This was the principle of the luxury sales taxes levied by the federal government during World War I. But the revenue significance of such luxury sales taxes is slight and they are more readily evaded than levies on mass consumption items, and the attempt thus to achieve progression in the commodity tax burden is a failure. A general sales tax which exempts foodstuffs may avoid being regressive, may even result in a progressive tax burden.

If for one reason or another a commodity or general sales tax cannot be shifted, it results in a very inequitable burden on the taxed producers or sellers. In effect it is a nonshiftable gross income tax, bearing no relation to the abilities of the taxpayers.

CHAPTER XXIII

Highway Taxes

THE present system of motor highways in the United States has been constructed and is maintained for the most part with funds derived from special taxation of the motorists who use these highways. These motorists are reached primarily by two state taxes—the motor vehicle license tax and the motor vehicle fuel tax¹ which during 1940 yielded \$388,000,000 and \$845,000,000 respectively. Taken together these two taxes produced over three times as much revenue as all the state income taxes, over twice as much as all the state business and corporation taxes, over one-and-one-half times as much as all the state and local sales and commodity taxes. Only property taxes are a more important item in the state and local tax system.

Gasoline taxes and motor vehicle charges have long been tacitly accepted as two levies to which the states have prior and dominant claim. Since 1932, however, the federal government has imposed a gasoline tax, and in 1941, with a vague intent to discourage somewhat the purchase and use of automobiles, it imposed a \$5 annual “use” charge.

MOTOR VEHICLE LICENSE TAXES

Of the two highway taxes, the motor vehicle license tax is older. It is by far the more complicated of the two levies, and offers the more interesting problems for study.

History

In its earliest form, the motor vehicle license charge was a fee rather than a tax. For regulatory purposes, the states compelled

¹ This term is used in preference to the more common “gasoline tax,” since the tax is generally extended to other motor fuels besides gasoline.

the registration of motor vehicles, and made charges of one, two, three, or five dollars to cover the cost involved. New York in 1901 was the first state to provide for auto registration. Within a few years most of the industrial states had enacted automobile registration statutes. By 1910, nearly all the states required automobile registration.

That automobile registration might become a source of revenue for financing state highway activities was an idea which developed slowly. Registration, originally required only on the purchase of an automobile, was in time made an annual function. The flat fees at first charged on the occasion of registration were increased in amount. In 1906, New Jersey, Ohio, and Vermont provided for the graduation of their registration taxes on the basis of the horsepower of the registered vehicle.

After 1906, motor vehicle license taxes grew complex in character and heavier in burden, and even the states which retained flat taxes for a while increased the charge. More and more states turned to taxes graduated on the basis of horsepower or other factors. Passenger vehicles and trucks were differentiated and the latter taxed on bases other than horsepower—on carrying capacity, on gross weight, and on net weight. Special truck taxes were sometimes levied in addition to a basic horsepower charge, sometimes in lieu of such a charge. On the theory that passenger cars were luxuries, while trucks were business instrumentalities, the former were at first taxed more heavily, but the inverse tendency soon developed and grew ever more marked. Also, during this period, the differentiation between automobiles in private use and commercial cars was initiated, heavier taxes being imposed on the latter.

In the 1920's the tendencies of the preceding period were continued. The rates of motor vehicle license charges continued to increase, though less rapidly, since many states were supplementing their motor vehicle license taxes with motor vehicle fuel taxes. Ever more states provided for discrimination between trucks and pas-

senger cars, and between private and commercial vehicles. As one state after another in the course of the decade levied special taxes on common carrier motor vehicles, a third element of discrimination was introduced. An unfortunate desire to adjust motor vehicle license taxes in minute detail to "cost-of-service" or "value-of-service" doctrines led the states to introduce a bewildering complexity of bases and rate schedules into their motor vehicle taxes.

Charges on private passenger cars have apparently achieved a degree of stability. But rate revisions for trucks, commercial vehicles, and common carriers have proceeded unabated, either to increase the revenue derived from these types of autos, or to adjust tax burdens more closely to some ideal of road use or road damage.

Bases

Motor vehicle license tax bases display bewildering variety. Most states have differing bases for passenger cars, trucks and buses, with superimposed variations for private, commercial and common carrier vehicles. And no two states have an identical combination of bases.

For the taxation of private passenger cars, net weight is the most prevalent base, being used either as sole base or in combination with others by two-thirds of the states. In most cases these net weight charges are progressive—the amount of fee increases more rapidly than the net weight base. Other bases, however, are far from uncommon. Horsepower, value of the car, and the age of car each appear as sole or part measure of the tax in a quarter of the tax laws; seating capacity and type of tire are taken into consideration in several. Examples of several types of passenger car tax bases are given in Table 27.

A few states do not discriminate between private passenger cars and private trucks, but the great majority either levy special additional taxes on private trucks, or else subject them to a different, heavier tax. While capacity is the most common base for these truck taxes, some states employ gross weight and net weight or,

more unusual, chassis weight and value. Trucks using solid or metal tires generally pay discriminatory higher rates. Several variations of truck registration charges are shown in Table 27.

Only a few states discriminate between commercial trucks and private trucks, but nearly all impose special taxes on buses and commercial passenger cars. Commercial passenger car taxes are levied on such diverse bases as value, gross weight, net weight, carrying capacity, seating capacity, mileage, passenger mileage, ton mileage, and the population of the city wherein operated.

Most states also place heavier taxes on common carrier passenger cars and trucks than on private or commercial vehicles. In some instances the base is the one used for taxing commercial vehicles, and the higher charge is accomplished through higher rates. More often common carriers are subject to special taxes in addition to those levied on commercial vehicles. Most common bases for the special taxes on common carrier passenger cars are seating capacity and gross receipts, while for common carrier trucks they are carrying capacity, ton mileage, and gross receipts.

Many states have special license taxes for electric and steam vehicles, motorcycles, trailers, tractors, taxicabs, buses, and other special road-using vehicles. It is interesting to note that electric and steam vehicles usually pay heavier license taxes than gasoline-driven vehicles, since the former do not pay motor vehicle fuel taxes. School buses are frequently charged a special low rate.

This complexity of tax bases has developed from the laudable desire of state legislatures to adjust motor vehicle taxation to the "benefit" principle, and in particular to apportion tax burdens in accordance with the road costs caused by different classes of vehicles. Logically, however, each of the many bases for motor vehicle license taxes found in the various states cannot be a perfect adjustment of tax burdens to benefit principles. Overrefinement of tax bases in an endeavor to achieve the "perfect" tax base has defeated itself, and some of the complex motor vehicle license taxes probably cause as much injustice as they prevent. Many of the special bases were introduced into motor vehicle license taxes in order to take the actual use of the public roads into account, but with the devel-

TABLE 27

EXAMPLES OF MOTOR VEHICLE LICENSE TAX SCHEDULES, 1940

| PRIVATE PASSENGER CARS | | | | | | |
|--|-----------------|----------|---------------------|--|---------------|----------|
| NORTH CAROLINA— <i>proportional weight</i> Per cwt —35¢ Minimum, \$7 00 | | | | UTAH— <i>flat rate</i> , \$5 00 | | |
| FLORIDA— <i>progressive weight</i> | | | | OKLAHOMA— <i>value</i> | | |
| Under 2,000 lbs | | \$ 5 00 | | Under \$600 | | \$12 50 |
| 2,000-3,000 lbs | | 10 00 | | Each additional \$100 | | 1 50 |
| 3,000-4,000 lbs | | 15 00 | | After first year, charge reduced by one-fifth | | |
| Over 4,000 lbs | | 20 00 | | ARKANSAS— <i>weight plus horsepower</i> | | |
| ILLINOIS— <i>horsepower</i> | | | | Under 3,500 lbs | 27½¢ per cwt | |
| Under 25 hp | | \$ 6 50 | | 3,500-4,500 lbs | 30 ¢ per cwt | |
| 25-35 hp | | 10 50 | | Over 4,500 lbs | 32½¢ per cwt | |
| 35-50 hp | | 17 00 | | 6½¢ per hp | | |
| Over 50 hp | | 22 00 | | One-half reduction of tax if car is over 5 years old | | |
| TRUCKS | | | | | | |
| DELAWARE— <i>gross weight</i> (same as for passenger cars) | | | | | | |
| Under 5,000 lbs, \$1 50 per 500 lbs | | | | | | |
| Over 5,000 lbs, \$2 00 per 500 lbs | | | | | | |
| ARIZONA— <i>net weight, axles, tires, value</i> | | | | | | |
| Net weight in lbs | | | | 2 Axles | 3 Axles | |
| 2,000- 4,000 | | | | \$ 35 per cwt | \$ 40 per cwt | |
| 4,000- 6,000 | | | | 50 per cwt. | 65 per cwt | |
| 6,000- 8,000 | | | | 65 per cwt | 80 per cwt | |
| 8,000-10,000 | | | | 75 per cwt | 1 00 per cwt | |
| 10,000-12,000 | | | | 1 00 per cwt | 1 35 per cwt | |
| over 12,000 | | | | 1 00 per cwt | 1 65 per cwt | |
| Rates double, if solid tires | | | | | | |
| Annual county tax 4% of value in incorporated city or town, 3% elsewhere. | | | | | | |
| COLORADO— <i>capacity, value and age</i> | | | | | | |
| 1 ton | \$10 00 | 1 year | 2 1 % of list price | | | |
| 1-2 tons | 17 50 | 2 years | 1 5 % of list price | | | |
| 2-3 tons | 25 00 | 3 years | 1 2 % of list price | | | |
| 3-4 tons | 37 50 | 4 years | 9 % of list price | | | |
| 4-5 tons | 50 00 | Older | 4½% of list price | | | |
| each additional ton | 25 00 | | | | | |
| PENNSYLVANIA— <i>chassis weight, number of wheels, tires</i> | | | | | | |
| Weight of Chassis in Lbs | Pneumatic Tires | | Cushion Tires | | Solid Tires | |
| | 4 Wheels | 6 Wheels | 4 Wheels | 6 Wheels | 4 Wheels | 6 Wheels |
| Under 2,000 | \$ 16 50 | | \$ 25 00 | | \$ 28 00 | |
| 2,000- 3,000 | 26 00 | \$ 40 00 | 35 00 | \$ 55 00 | 45 00 | \$ 65 00 |
| 3,000- 4,000 | 35 00 | 50 00 | 50 00 | 65 00 | 60 00 | 75 00 |
| 4,000- 5,000 | 45 00 | 60 00 | 60 00 | 70 00 | 75 00 | 90 00 |
| 5,000- 6,000 | 63 00 | 90 00 | 85 00 | 125 00 | 105 00 | 150 00 |
| 6,000- 7,500 | 90 00 | 155 00 | 125 00 | 200 00 | 150 00 | 275 00 |
| 7,500- 9,000 | 110 00 | 175 00 | 150 00 | 225 00 | 190 00 | 300 00 |
| 9,000-12,000 | 155 00 | 200 00 | 200 00 | 250 00 | 300 00 | 325 00 |
| Over 12,000 | 155 00 | 225 00 | 200 00 | 275 00 | 300 00 | 350 00 |

opment of the motor vehicle fuel tax, whose burden is closely related to road use, further need for these elements in the motor vehicle license taxes is obviated.

Road tests indicate that highway construction and maintenance costs are related to the weight and resiliency rather than to the speed or motive power of the vehicles using the highways. Therefore, it is argued, a single base of gross weight with special charges for vehicles with solid or metal tires is the best practical basis for motor vehicle license charges. Cost of highway construction and maintenance is greater, and more than proportionately greater, for heavy commercial vehicles than for private cars. The former necessitate extra-width roadways, more solid and expensive roadbeds, and more substantial bridges. And road damage by vehicles increases progressively in relation to their weight. A motor vehicle license charge based on gross weight should, therefore, be progressive—the *rate* should increase as the gross weight of the taxed vehicle increases.² Passenger cars and trucks need not be differentiated under a progressive gross weight tax, since the greater gross weight of the latter makes them subject to the higher rates of the progressive schedule. Neither need there be discrimination between private and commercial vehicles. Since the latter use the public highways more extensively, they are compelled to pay more gasoline taxes.

Motor vehicle common carriers may properly be considered a special class of vehicle, and taxed accordingly. As public service enterprises, the operating companies may logically be brought under a state's general system of public utility taxation. This is frequently done. But, as noted above, a number of states have developed special taxes, based on seating or carrying capacity of the buses or

² A committee of the National Tax Association has suggested a standard formula for motor vehicle license charges, which would accomplish the progression suggested above by employing the square of the gross tonnage of the vehicle as a factor. The formula is

$$\text{tax} = c + m(w^2)$$

"c" is a constant fee that might range anywhere from \$3 to \$10 "m" is a multiplier which might range from 2 to 10 "w²" is, of course, the squared tonnage weight of the vehicle Under this formula, with c = \$5 and m = 4, a passenger car weighing less than a ton would pay 5 + 4(1²) or \$9, while a ten-ton truck would pay 5 + 4(10²) or \$405. See *Proceedings of the Twenty-Third National Tax Association Conference* 1930, p. 161

trucks, on mileage operated, and on gross receipts,³ for motor vehicle common carriers. No special merit or condemnation attaches to either system.

Rates

Each state is law unto itself in setting motor vehicle tax rates. Variation in these rates is so wide that no general statement can be made concerning them. The extent of this variation is indicated by the following tabulation, derived from a survey made in 1930:

TABLE 28
VARIATION IN MOTOR VEHICLE LICENSE TAX CHARGES, 1930
(Tax rates of various states applied to uniform car specifications)

| Type of car | Low | High |
|-----------------------------------|--|---|
| Private car | <i>D C</i> , \$1 00, <i>Cal.</i> , \$3 00, <i>Ariz</i> , \$3 50 | <i>Iowa</i> , \$152 00, <i>N M</i> , \$230 00, <i>Minn.</i> , \$240 00. |
| Non-common-carrier bus | <i>D C</i> , \$12 00, <i>Md</i> , \$14 40, <i>Mass</i> , \$33 00 | <i>S D</i> , \$785 00, <i>Utah</i> , \$1,-000 00, <i>Minn</i> , \$1000 00 |
| Common-carrier bus | <i>D C</i> , \$12 00, <i>Mass</i> , \$33 00, <i>Mont</i> , \$35 00 | <i>Utah</i> , \$1000.00, <i>Menn</i> , \$1,-000 00; <i>Iowa</i> , \$1,007 75. |
| Private truck | <i>D C</i> , \$1 00, <i>Md</i> , \$11 20, <i>Mass</i> , \$19 50 | <i>Ark</i> , \$125 00, <i>Mass</i> , \$125 00, <i>N M</i> , \$134 00 |
| Non-common-carrier truck for hire | <i>D C</i> , \$1 00, <i>Md</i> , \$11 20, <i>Mass</i> , \$19 50 | <i>Minn</i> , \$450 00, <i>Ga</i> , \$452.50, <i>Utah</i> , \$771 25. |
| Common-carrier truck | <i>D C</i> , \$1 00, <i>Mass.</i> , \$19 50, <i>Mo</i> , \$30.00 | <i>Cal</i> , \$750.00, <i>Utah</i> , \$771 25, <i>N. C</i> , \$900.00. |

Derived from C. H. Sandage and R. W. Nelson, *Motor Vehicle Taxation for Highway Purposes* [University of Iowa, Bureau of Business Research, Iowa Studies in Business, No. 11, 1932], pp 54-55, 61

Reciprocity

All states honor the registration of passenger cars bearing license plates of the state of the owner's domicile. Although a few states require special "entrance" registration of "foreign" cars, they charge no tax.

³ Unlike gross receipts taxes on railroads, gross receipts taxes on motor vehicle common carriers can be based not only on gross receipts from intrastate service but also upon allocated gross receipts from interstate service, provided that the tax is levied as an excise for the privilege of using the public highways—*Interstate Transit Inc. v. Lindsey*, 283 U. S. (1931) 183

Such universal recognition of "home" registration does not apply to contract and common carrier buses and trucks. The statutes of a third of the states contain reciprocity clauses which eliminate double taxation of all or certain classes of motor carriers among themselves. But carriers with a "home" registration or operating in the other two thirds of the states must pay a registration tax to every state in which they operate. In some cases the registration tax on "foreign" carriers is established at a half or a third of the tax on "home" vehicles. But in Florida the tax on "foreign" carriers is double the tax on "home" vehicles. This current multiple taxation of motor carriers is a serious abuse of the principles of motor vehicle taxation and one, it is to be hoped, which will soon be eliminated by extension of reciprocity.

Administration

The motor vehicle license tax has often been described as a tax which can be neither evaded nor avoided. In one sense this statement is true, since every car operating on the public highways must take out a license, and a tax must be paid to obtain the license.

But a certain routine is needed to prevent passenger car and truck owners from understating the weight, or capacity, or horsepower of their vehicles when applying for license, with intent to reduce the amount of their tax payments. Initial license applications must be checked against dealers' certificates, and license renewal applications must be checked against the stubs of the old registrations. If this routine is performed faithfully, a motor vehicle tax is almost impossible to evade. But if it is neglected, partial evasion of the tax is likely to become widespread. Good administration is as essential to successful motor vehicle taxation as to any other tax.

Unfortunately, only a small minority of the states have turned the administration of the motor vehicle license tax over to the agency best fitted for it—the state tax commission or state revenue department. County officials still administer the tax in five states. In eleven states this function has been left with the secretary of state or state auditor, in another seventeen, with the state highway department. From all reports, the state highway departments make

a reasonably good showing in their administration of the motor vehicle license tax, though they are not primarily equipped to be tax-collecting agencies. But the handling of this tax by county officials and by the offices of the state secretaries of state is often grossly indifferent. Such scattered evidence as is available points to the probability of considerable evasion of the motor vehicle license tax in the states where these agencies still administer it.

MOTOR VEHICLE FUEL TAXES

Originally imposed as a minor supplementary levy to cover the factor of highway use, the motor vehicle fuel tax has become the major source of highway revenue in most states. The structure of the fuel tax is simple, and it is relatively easy to administer.

History

Before the motor vehicle fuel tax was considered as a state tax, it was proposed as an item of federal revenue. President Wilson recommended it in 1915, and a gasoline tax, later dropped, was included in early drafts of the 1918 revenue bill.

Oregon in 1919 was the first state to enact a motor vehicle fuel tax law. The idea was current in the legislative atmosphere, however, and during the same year three other states—Colorado, New Mexico, and North Dakota—enacted such taxes. Within the next few years, gasoline taxes were voted in one state after another. Ten years after the first motor vehicle fuel tax was levied, every state had one. The federal government has also superimposed a gasoline tax since 1932; the rate is now $1\frac{1}{2}$ cents per gallon.

Three distinct developments are to be noted in the twenty-year history of the motor vehicle fuel tax. The earlier levies were specifically gasoline taxes—they applied only to the sale of gasoline. When it was found that various motor vehicle fuels were being sold without tax, on the argument that while they were petroleum derivatives they were not specifically gasoline, the taxes in many states were tightened by extending them to other motor vehicle fuels.

In many states the constitutional basis of the motor vehicle fuel tax is its character of special charge to defray highway costs. Some

Scope

A motor vehicle fuel tax is a special retail sales tax, collected usually on the sales by distributing companies to service outlets, but alternatively collectible from service outlets selling to their customers. Like retail sales taxes generally, it encounters few constitutional restrictions. For a while it seemed possible that the tax might be hampered by a recrudescence of the old "original package" doctrine of interstate commerce,⁴ but this danger was soon eliminated. In clear-cut decisions, the Supreme Court held that once motor fuel has entered a state for disposal therein, it is subject to state taxation on its sale,⁵ storage, or use.⁶ Gasoline sold to federal agencies is held to be a federal instrumentality and not subject to state taxation.⁷ Construction of several state constitutions compels the motor vehicle fuel taxes of those states to be levied solely as highway excises, with exemption for fuel not used in highway transportation, and with all revenue from the tax earmarked for road construction or road maintenance.

Very few states limit motor vehicle fuel taxes to gasoline. Instead, the state taxes generally cover all motor fuels, kerosene excepted; the federal "gasoline" tax is specifically extended to all motor fuels. Most states allow a rebate for taxes paid on motor fuels intended for purposes other than transportation on the public highways, thus emphasizing the "benefit" character of the tax. Lately however, in contradiction to this principle, several states have extended their taxes to cover gasoline utilized by airplanes, or have levied special supplementary taxes on aviation gasoline.

Large-scale consumers of motor fuels—trucking companies, railroads, aviation companies, and others—formerly avoided state motor fuel taxes by purchasing their supplies of fuel from distributors in other states. Because of the interstate commerce limitation, such

⁴ *Askren v Continental Oil Co*, 252 U S (1920) 444; *Bowman v Continental Oil Co*, 256 U S (1921) 642

⁵ *Sonneborn Brothers v Cureton*, 262 U S (1923) 506.

⁶ *Eastern Air Transport Co v. South Carolina Tax Commission*, 285 U. S. (1932) 147, *Gregg Dyeing Co v Query*, 286 U S. (1932) 472, *Nashville, C & St L Railway v Wallace*, 288 U S (1933) 249, *Edelman v Boeing Air Transport*, 288 U S (1933) 595

⁷ *Graves v the Texas Co*, 298 U S (1936) 393

interstate purchases were not taxable by the seller's state. To check this avoidance, forty-five states have enacted gasoline "use" taxes as supplements to their motor vehicle fuel taxes. These "use" taxes apply to gasoline bought outside the taxing state for resale or use within its borders.

Rates

In their twenty years' history, the rates of state motor vehicle fuel taxes have consistently tended to rise. At present, the range is from two to seven cents per gallon. To these varied state taxes must be added the federal tax of one and one-half cents. Three-quarters of the states allow a deduction on the tax to cover shrinkage in the handling of the fuel from the time the tax is paid until its sale to ultimate purchasers; the amount of this rebate varies from one-half per cent in Virginia to four per cent in South Dakota. A few states also allow the distributors who originally pay the tax a small rebate to cover their special accounting labors.

Administration

The federal motor fuel tax is imposed on gasoline distribution at the point where the business is concentrated in the fewest hands—the producers and importers. No matter what the subsequent channels of distribution, the federal tax is passed on through all successive transactions until it comes to rest finally on American motor fuel users.

States cannot impose their motor fuel taxes on the conveniently small number of producers and importers, since the gasoline produced in any state is not necessarily consumed there nor is the gasoline consumed in a state necessarily produced there. The best focal point for the state taxes is the wholesale distributor of the motor fuel, and all states make him primarily responsible for motor vehicle fuel tax payments.⁸ Practically all gasoline sold at retail in any state is handled by such wholesalers, they are far fewer in number

⁸ A sample motor vehicle fuel tax form is reproduced in Appendix G, p. 847 of this volume.

than the retail service outlets, and they can legally be taxed on all sales made within the state. If a retailer buys his supply of motor fuel from a distributor operating in another state, he is either reached under a "use" tax, or he is made responsible for the payment of the regular gasoline tax when he makes his sales to customers. Motor fuel users who purchase from distributors or retailers in other states are individually liable under "use" taxes.

Administration of the motor vehicle fuel tax has been given to the state tax commission or department of revenue in twenty-five states, to the state highway department in five. In the remaining states the tax is collected by such diverse offices as the secretary of state, the state controller or auditor, the state treasurer, and the state department of agriculture. Although the tax is not difficult to administer, with indifferent administration evasion can be considerable. Tax rebates for gasoline not used in highway vehicles provide a broad loophole for evasion. Filling stations and large-scale consumers buy their fuel from distributors in other states, and make no reports for "use" taxation. Fly-by-night distributors establish themselves, sell to service stations at a cut rate, and disappear without making any tax payments—only to reappear as new companies under new names and repeat the process. The phenomenally low ratios of administrative costs to motor fuel tax collections reported from states where the tax is not administered by a tax commission, revenue department, or highway department, are not necessarily indications of efficiency. More probably, they are evidence that the collecting agencies are merely accepting whatever revenue comes in voluntarily and are making no serious attempts to check the evasion which undoubtedly occurs.

THEORETICAL CONSIDERATIONS

Since the motor vehicle fuel tax is a pure form of specific commodity tax, most of the discussion of the theory of commodity taxation in the preceding chapter is directly applicable. But the motor fuel tax does raise several special and interesting questions in distributive theory. As for the motor vehicle license tax, it cannot be classified with any other group of taxes, but because of its close con-

nection with the motor vehicle fuel tax, its theoretical principles can be most conveniently considered in connection with that tax.

Incidence

Motor fuel is a commodity for which demand, within the limits affected by the rates of the present gasoline taxes, is relatively inelastic. Under the rules of commodity tax incidence previously discussed,⁹ the motor vehicle fuel tax, whether paid by wholesale distributors or by retail filling stations, is shifted practically in its entirety to gasoline users. To facilitate full and exact shifting, and to emphasize the point that the tax is intended to rest on gasoline users and not on gasoline sellers, most states require filling stations to post separately the tax per gallon and the net price per gallon of the motor fuel.

When taxed fuel is used to propel private cars, there is no possibility of further tax shifting, since there are no business relations to make this possible. The tax on fuel used by commercial vehicles is probably shifted in part, since all business enterprises making automobile deliveries must pay a similar tax on their consumption of motor vehicle fuel. But the lack of uniform relation between the use of motor vehicle fuel and the gross receipts of the concerns employing motor vehicles, makes it improbable that the tax on fuel consumed by commercial vehicles is entirely shifted. A more uniform shifting of the motor vehicle fuel tax is probable in the case of motor vehicle common carriers, inasmuch as their consumption of taxed motor vehicle fuels is somewhat related to their gross receipts.

As in the case of the motor vehicle fuel tax and for the same reasons, the motor vehicle license tax on private cars cannot be shifted, while that on commercial cars may be more or less shifted. Gross receipts license taxes, mileage, passenger mileage, and ton mileage taxes on the motor vehicles of common carrier companies are probably generally shifted, since each of these bases bears a fairly consistent relationship to the gross receipts of these companies.

⁹ See pp. 234 ff. of this volume

Distributive considerations

The motor vehicle license tax and the motor vehicle fuel tax are the supreme modern examples of taxes levied under the "benefit" theory of taxation. Motor vehicle owners derive special individual benefit from the construction and maintenance of motor highways. By means of the two highway taxes, they are compelled to defray in some states part, in other states all, of the cost of building and maintenance. How influenced legislators have been by the "benefit" doctrine of taxation in this respect is indicated by the preamble to the original Delaware motor vehicle fuel tax, which stated that:

the present system of charging license fees for the regulation of motor vehicles was designed in part to equalize the burden of constructing, reconstructing and maintaining the public roads and highways of the State of Delaware by imposing said burden on those deriving special benefit; it is deemed that there is a direct relation between the use of highways by motor vehicles and the quantity of motor vehicle fuel consumed in furnishing the motive power thereof; it is considered and deemed that a tax levied upon each gallon of motor vehicle fuel purchased for use of motor vehicles is equivalent to, and in its practical effect is a license tax upon the motor vehicle itself.¹⁰

Many state legislatures, it is clear from a study of the various motor vehicle license taxes, have not been able to decide whether they are taxing according to the "cost-of-service" doctrine, or according to the "value-of-service" doctrine. When motor vehicles having solid or metal tires are taxed more heavily than those having pneumatic tires, the legislators clearly have in mind the greater destruction of roadbeds and surfacing caused by solid or metal tires. The "solid-tire discrimination" in motor vehicle license taxes is an example of "cost-of-service" taxation. When commercial vehicles are charged more than privately owned vehicles of the same size and capacity, it is probable that "value-of-service" is the principle behind the discrimination. And some legislatures seek further support for highway taxes under the "ability" doctrine, by levying motor vehicle license taxes based on value.

¹⁰ *Delaware Statutes*, 1923, Ch 14.

Motor vehicle fuel taxes are also defended by both the "cost-of-service" and "value-of-service" doctrines. Gasoline consumption by automobiles is related to the mileage they travel and to the weight and motor power of the vehicle. It has been argued on the one hand that an automobile damages the highways over which it travels in proportion to the distance it covers and its weight and power, so that a motor vehicle fuel tax prorates costs of constructing and maintaining motor highways among those who necessitate the construction and repair. On the other hand, it has also been argued that the presence of state-built highways benefits automobile owners more or less in proportion to the mileage they travel and to the weight and power of their cars. According to this second argument, a motor vehicle fuel tax distributes highway cost pro rata to the benefit which different individuals derive from the existence of motor highways.

At first sight it may appear that the shifting of motor vehicle license and fuel taxes on commercial and common carrier vehicles destroys the direct application of the "benefit" theory. It may be argued, however, that the customers of business concerns using motor vehicles benefit from the existence of public highways through better delivery service and lower delivery costs. In shifting the tax to their customers, therefore, business concerns originally subject to highway taxes are shifting them to those individuals who derive the ultimate benefit from the use of the highways by commercial vehicles.

Highway taxes in relation to highway costs

According to "cost-of-service" theory, motor vehicle owners should pay, through highway taxes, all the costs of highway construction and maintenance for which automobile traffic is responsible. Most students of highway finance accept this view, and many have sought to compute the proportion of highway costs attributable to automobile traffic and the proportion attributable to other traffic, as a first step in calculating the revenue which the states should raise from highway taxes. In general all agree that the entire cost of state motor highways, and some share of the cost of local

roads and arterial city streets, should be covered by such taxation.¹¹

This conclusion is none too welcome to the American Automobile Chamber of Commerce and other automobile interests. They argue, in protest, that besides specifically benefiting automobile owners, motor highways confer a general social benefit upon the population by providing greater facilities for travel and communication. Holdings of neighboring property owners are in many instances greatly enhanced in value by the creation of motor highways. According to the automobile interests, a considerable proportion of motor highway costs should be financed out of general tax revenues.

Quite naturally, railroad interests would like to see their motor transport competitors hampered by high tax costs. Spokesmen for the railroads suggest that highway taxes may be based on "ability" principles just as well as upon "benefit" doctrines. Ownership of passenger cars is spread more widely and approximates the distribution of wealth and income more closely than does ownership of real property; hence there is a better argument for raising general revenues from highway taxes than from property taxes. And the motor-transport aspect of business is no more unreasonable than the property-ownership aspect as a basis for business taxation. If, according to the railroad spokesmen, highway taxes be considered a source of general tax revenue, the rates of gasoline and auto-registration taxes can be raised far higher than is necessary merely to produce revenue sufficient for highway costs; the surplus revenue can be used for state general fund purposes.

During the early 1920's, the revenue derived from highway taxes fell far short of covering motor highway maintenance costs and highway debt service. Influenced by fiscal considerations rather than any conclusions of the tax theorists, the state legislatures continued to vote ever higher motor vehicle registration and gasoline tax rates. By 1930, according to a later survey,¹² highway tax rev-

¹¹ See Harold G. Moulton and associates, *The American Transportation Problem* (Brookings Institution, Washington, 1933), p. 556; "Urgent Problems of Motor Vehicle and Related Taxation" (committee report), *Proceedings of the Twenty-Seventh National Tax Association Conference*, 1934, p. 274.

¹² Moulton and associates, *op. cit.*, pp. 547 ff.

enues more than covered state and local highway maintenance and amortization costs

"Diversion" of highway tax revenues

Influenced by "benefit" doctrines, most state legislatures at an early date earmarked the receipts from auto registration and motor vehicle fuel taxes to special "highway funds," from which were made all payments for state highway construction and maintenance and for state highway aid to local governments. Since the highway taxes rarely produced enough revenue to cover highway expenditures, additional annual appropriations were made from the states' "general funds" to their "highway funds."

Recently, to further budgetary control, some states have ended this earmarking of highway taxes, and have directed their payment into the "general funds." In these states, appropriations are made to the state highway departments like any other departments, and the expenditures of the highway departments are paid out of the states' "general funds." Automobile interests claim that this is "diversion" of highway taxes from their proper function, and protest bitterly.

So long as a state and its local governments are spending more on motor highways than is produced by highway taxes, it is ridiculous to call "general fund" handling of highway taxes "diversion." The only alteration effected is one of accounting routine. No modification of highway construction and maintenance programs is necessarily involved, nor are highway tax rates in any way affected. But in some of these states, highway expenditures were so cut during the depression that they fell below the level of receipts from highway taxes. Some highway tax revenue was definitely used for other than highway purposes—was really "diverted," according to the automobile interests. If these taxes had remained earmarked to the state "highway funds," this could not have happened. Extra appropriations to the state "highway funds" might have been cut or even eliminated, but the highway departments would have had the full amount of the highway taxes for their budgets.

Whether or not this true "diversion" of highway tax revenues

to other purposes is to be criticized depends on the theoretical view taken of the highway taxes. If they are considered an exceptional type of "benefit" levy, then the "diversion" is reprehensible. But if the auto registration tax and motor vehicle fuel tax are accepted as merely two more methods of obtaining tax revenue, to be judged by the same standards as any other tax, the charge of "diversion" becomes meaningless.

Florida earmarks all motor vehicle license tax revenue to its school fund. Florida, Georgia, and several other states devote part of their motor vehicle fuel tax receipts to school purposes. And during the 1930's several states earmarked part of their fuel tax revenue to relief expenditures. No more stupid arrangement could be imagined. To begin with, any earmarking of revenue is bad, because it breaks down budgetary control. Earmarking highway revenues to a "highway fund" receives some slight justification from the popular association of the taxes and the expenditures in question, and probably soothes resentment against the highway taxes. But when an automobile registration tax or a motor vehicle fuel tax is earmarked to school or relief expenditure, every disadvantage of earmarking is incurred, without a single compensating advantage.

CHAPTER XXIV

Non-Tax Revenues

THE five to ten per cent of American governmental revenue not derived from taxation comes from many diverse sources—from sales of certain types of capital property, from investment profits, dividends and interest, from the federal government's coinage right, from expropriation powers, from fines and penalties, from gifts, from fees, and from special assessments. Problems raised by these minor sources of revenue are perhaps not so crucial as those raised by taxation, because the sums involved are not so important. But problems there are, many and varied, that deserve consideration by students of Public Finance.

CLASSIFICATION OF NON-TAX REVENUES

Practically every writer who has touched upon the subject of governmental revenues has propounded his own classification. Which is as it should be, for classification of some sort is a necessary first step to analysis. As in the case of expenditure classifications, revenue classifications are useful tools for students in the field of Public Finance. But the use of each classification is likely to be limited fairly closely to the particular line of analysis for which it was constructed. Any absolute, all-purpose classification of governmental revenues is almost a contradiction in terms.

One classification of governmental revenues frequently proposed is the "historical." The basis of this classification is the theory that a parallel development in governmental revenues has occurred for all, or at least most, states. Under this classification, first place is given to gifts, second place to subsidies and tribute, third place to the sovereign prerogatives of fines, coinage, escheat, wreck, and so forth, fourth place to forced contributions of personal services for specific objects (such as road labor), fifth place to indirect taxa-

tion, and final place to direct taxation. It should be noted that the assumption of uniformity in the historical development of public revenues which underlies this classification is open to serious question. Furthermore, this classification is of little assistance in studying present tax systems.

A second classification of governmental revenues has been described as "administrative." It separates from other current revenues, the revenues from public utilities and from taxation. Its virtue is that it permits independent study of the finances of public utilities to determine whether they are self-sustaining. Its disadvantage is that it lumps together many diverse sources of revenue under the heading "miscellaneous," preventing an analysis of similarities and dissimilarities in the characters and effects of these various items of governmental revenue.

A third classification of governmental revenues is called "causal." It divides all revenues into three classes—gratuitous, contractual, and compulsory. The first class covers only gifts. The second includes sales of the public domain and the income from public utilities. The third class encompasses all other forms of current revenue, including expropriation under the power of eminent domain, fines and penalties, fees and license charges, special assessments, and taxes. This classification also has the disadvantage of grouping together diverse elements of current revenue which, though they have one common attribute—the compulsory nature of the relationship between the government receiving the revenue and the individual paying it—are otherwise, in their characters and effects, grossly dissimilar.

Still a fourth classification goes by the name "functional." This classification of governmental revenues is related to the "functional" classification of governmental expenditures according to whether they confer a private benefit on individuals or a general social benefit. The "functional" classification of current revenues divides them into: (1) prices for public utility services, (2) fees, license charges, and special assessments which may be levied when a governmental activity confers a special benefit on particular individuals as well as a general social benefit, and (3) all other forms of governmental

TABLE 30
FEDERAL, STATE, AND LOCAL NON-TAX COLLECTIONS
(Amounts in millions)

| Items | Federal ¹ | State ² | Counties ³ |
|-------------------------------|----------------------|--------------------|-----------------------|
| Profits of enterprises | \$ 60 | \$ 52.7 | \$ 3 |
| Interest | 17.6 | 94.5 | } 19.1 |
| Rents and royalties | 24.5 | 25.9 | |
| Total investment revenues | \$ 48.1 | \$173.1 | \$ 19.4 |
| Fees and other charges | \$ 17.0 | \$186.4 | \$ 89.0 |
| Special assessments | | 1.8 | 32.1 |
| Total special charges | \$ 17.0 | \$188.2 | \$121.1 |
| Coinage right | \$ 97.7 | \$ 8.6 | \$ 10.3 |
| Fines, forfeits, and escheats | 5.9 | 10.3 | |
| Gratuities | 2.7 | | |
| Total sovereign revenues | \$106.3 | \$ 18.9 | \$ 10.3 |
| Total non-tax revenues | \$171.4 | \$380.2 | \$150.8 |
| Tax revenues | \$5,659.5 | \$3,594.9 | \$1,020.8 |

| Items | Municipalities ³ | School Districts ³ | All others ³ |
|-------------------------------|-----------------------------|-------------------------------|-------------------------|
| Profits of enterprises | \$204.1 | | \$ 13.8 |
| Interest | } 131.0 | \$ 10.6 | 7.4 |
| Rents and royalties | | | |
| Total investment revenues | \$335.1 | \$ 10.6 | \$ 21.2 |
| Fees and other charges | \$ 87.4 | \$ 63.5 | \$ 17.3 |
| Special assessments | 226.4 | | 36.5 |
| Total special charges | \$313.8 | \$ 63.5 | \$ 53.8 |
| Coinage right | | | |
| Fines, forfeits, and escheats | \$ 19.4 | \$ 1 | \$ 7 |
| Gratuities | | | |
| Total sovereign revenues | \$ 19.4 | \$.1 | \$.7 |
| Total non-tax revenues | \$668.3 | \$74.2 | \$75.7 |
| Tax revenues | \$2,251.3 | \$1,121.0 | \$322.7 |

¹ Fiscal year 1940 ² Fiscal year 1938. ³ Fiscal year 1932.

Derived from United States Secretary of the Treasury, *Annual Report, 1940*, Table 1, United States Bureau of the Census, *Financial Statistics of States, 1938*, and *Financial Statistics of State and Local Governments, 1932*.

revenue which can properly be expended upon governmental activities conferring a general social benefit. This classification, like the two preceding, lumps into one category many items of current governmental revenue which have little or no resemblance to each other.

None of these classifications creates quite the right background for the discussion of American non-tax revenues which follows. So, with due apologies, still another variant is added to the already long list of revenue classifications:

1. Commercial revenues:
 - a. Disposal of the public domain and other properties
 - b. Investment income.
 - i. Profits of enterprises
 - ii. Interest on investments
 - iii. Interest on deposits
 - iv. Rents and royalties
 - c. Lotteries
2. Charges for special governmental services:
 - a. Service fees
 - b. License fees
 - c. Special assessments and excess condemnations
3. Sovereign revenues:
 - a. Tribute or subsidy
 - b. Coinage right
 - c. Expropriation and escheat
 - d. Fines, penalties, and forfeitures
 - e. Gratuities

Table 30 indicates the relative importance of these non-tax items in the revenue systems of some of the American governments.

DISPOSAL OF THE PUBLIC DOMAIN AND OTHER PROPERTIES

By the public domain is meant that land which governments own in fee. Local governments generally use their land for building sites, parks, and streets. Much of the land owned by the federal and state governments, on the contrary, is waste or unoccupied land, though often of great value for agricultural, lumbering, or

mining purposes. This land is free of governmental buildings and is not used in connection with any governmental activities. The federal and state governments can sell or otherwise dispose of these land holdings without curtailing any of their regular functions. From the sale and lease of parts of the federal domain the federal government has obtained over \$100,000,000 in the past hundred and fifty years. State governments, with a smaller land area at their disposal but actuated by more purely fiscal motives than the federal government, have derived as much, if not more, revenue from the sale of state domains.

Issues of public domain disposal

Into the problem of the disposal of the public domain enter considerations not purely fiscal. Openhanded disposal of public lands encourages settlement and national development. Restricted disposal permits conservation and public control of natural resources. These factors are of supreme social importance and, rather than the purely fiscal issue of obtaining or foregoing an item of revenue, must be the basis for deciding questions of the disposal of the public domain. Gratuitous distribution of the public domain to encourage the exploitation of these lands by farming, mining, or lumbering, leads to heavy production of cheap raw materials and hence to rapid national development as long as that policy continues, but it puts little or no revenue into the government treasury. A policy of conservation, on the contrary, permits of a revenue from the public domain, either through direct sale at market prices or through renting and leasing rights in the property.

Disposal of the federal domain

By cession from the states, by occupation, conquest, and purchase, the federal government acquired 2,484,220 square miles of territory in continental America between 1781 and 1867. The Northwest Territory, ceded by the states to the federal government between 1781 and 1802, was the first federal land acquisition. This was followed by the purchase of the Louisiana Territory from France in 1803, the purchase of Florida from Spain in 1819, the cession of

Indian Territory by Texas in 1845, the acquisition of Oregon Territory by occupation and by treaty with England in 1846, the acquisition of southwestern United States by conquest and purchase from Mexico in 1848, the Gadsden Purchase in 1853, and the purchase of Alaska from Russia in 1867. Except for such private properties as had already been established upon it, this domain belonged to the federal government in fee. It could be sold or given away, with or without conditions.

Congress was at first inclined to treat this property as a private domain owned by the government, and on this basis sold parcels of land in the Northwest Territory to individuals and land companies for the best price obtainable, using the proceeds to retire the national debt. This policy proved abortive, and in the Land Acts of 1796 and 1800 Congress provided for sales of small parcels of land on credit to individual settlers. Between 1796 and 1820, \$27,663,964 was obtained from such sales. The system of credit sales seemed likely to force the federal government into the role of dunning creditor, and in 1820 all land sales were placed on a cash basis. For forty years, these sales were a lucrative source of federal revenue; in the boom years 1835 and 1836 land sale receipts were respectively \$15,000,000 and \$25,000,000.

Public policy was given precedence over fiscal policy in the Homestead Act of 1862, which provided for free acquisition of land by settlement and cultivation. Unfortunately, the Homestead Act permitted "commutation"—settlement and cultivation requirements might be avoided by purchase of the land at \$1.25 or \$2.50 an acre. Furthermore, purchases at \$1.25 per acre could still be made, until 1879, under the Land Act of 1841. Taking advantage of this loophole, mining and lumber companies obtained title to immense areas of valuable timber and mineral lands by "dummy" homestead entries. Large arable tracts were engrossed by speculators, to the detriment of true settlers. From 1881 to 1904, it is estimated, nearly one-quarter of the public domain transferred to private ownership under the Homestead Act was obtained by commutation, and the federal Treasury received from \$2,000,000 to \$12,000,000 a year from land sales.

TABLE 31
FEDERAL LAND ACTS, 1785-1934

| Land Act | Minimum Acre Allot- ment | Minimum Acre Price | Terms of Payment |
|------------------------------|-----------------------------------|--------------------------|--|
| Ordinance of 1785 | 640 | \$1 00 | Cash or debt certificates calculated at specie value. |
| Land Act of 1796 | 640 | 2 00 | One-twentieth of purchase price paid immediately, balance in four annual instalments |
| Land Act of 1800 | 320 | 2 00 | Liberal credit Payment in specie or government bonds |
| Land Act of 1820 | 80 | 1 25 | Cash. |
| Preemption Act of 1841 | 160 | 1 25 | Cash. Settlers on land had first right to purchase |
| Homestead Act of 1862 | 160 | free | Title confirmed after five years' settlement and cultivation of the land |
| Timber and Stone Act of 1878 | 160 | 2 50 | Mineral and timber land to be sold at appraised value |
| Land Act of 1909 | 320 | free | Dry farming land, same terms as Homestead Act |
| Land Act of 1912 | | | Five-year Homestead Act term reduced to three years |
| Land Act of 1916 | 640 | free | Cattle land patents. |
| Proclamation of 1934. | | | No further grants |

Besides the major purpose of settlement, the federal government has in the past utilized the national domain for certain special ends. Land allotments were given to soldiers as service bonuses during the Revolutionary War, the War of 1812, and the Mexican War; over 61,000,000 acres had been so distributed by 1880. Such lands were granted by transferable warrants, and in practice the result was land speculation rather than actual settlement by soldiers. Furthermore, in the interest of internal improvements, private corpo-

rations and the states received liberal grants throughout the nineteenth century. During the early years, some 10,000,000 acres were granted to assist the construction of wagon roads and canals and to encourage river improvement. The third quarter of the century saw princely grants in aid of railroad construction, reaching the staggering total of 129,000,000 acres. Federal grants to the states were frequently regranted by them to aid internal improvement. Over 64,000,000 acres of swamp land were donated to the states on condition that they be drained and improved.

One of the earliest and most enduring elements of federal land policy was the provision for the support of education by land grant. In every township created out of the federal domain, four sections were set aside as "school lands," and the proceeds from their sale were reserved as a local school fund. All but eighteen states¹ received school grants from the federal domain. In 1862 Congress voted each state 30,000 acres of federal land per congressman, the proceeds from the sale of these lands to be devoted to establishing agricultural colleges. Special grants were made for the support of state universities and in some cases private universities. In all, the federal government donated over 115,000,000 acres to the furtherance of public education.

There was never any reason why the federal government should have freely disposed of its timber and mineral lands. On the contrary, all the logic of economics pointed to the desirability of maintaining some element of control over timber and mineral exploitation by retaining title to such lands. Nevertheless, millions of acres of supremely valuable mineral and timber land passed from national to private ownership at nominal prices. Not until 1891 were public lands classified with a view to reserving timber property from occupation under homestead claims and no withdrawals under this act were made until the 1900's—by then the best part of our forest lands had been lost to the nation. Coal lands and lands known or believed to contain mineral deposits were not withdrawn

¹ The original thirteen states together with Kentucky, Maine, Texas, Vermont, and West Virginia, which were not formed out of the federal domain.

from private acquisition until 1905—and by then most of our tremendous mineral reserves had become private possessions

Although the “conservation movement” of the 1900’s closed the stable door after most of the best horses had been stolen, the mineral resources saved to the nation are not inconsiderable. The mineral areas of the remaining domain are estimated to contain 200,000,000,000 tons of coal, 8,000,000,000 tons of phosphate, an uncalculated tonnage of potash, sixty-five developed oil and gas fields, and deposits of oil shale from which some 60,000,000,000 barrels of oil can be obtained. Potential water power on federal lands has been calculated at 18,000,000 horsepower—more than the total at present developed and used. These natural resources are not alone a national heritage to be preserved from spoliation; they represent an important potential source of federal revenue. Royalties on lumbering and mining patents already yield \$8,000,000 to \$10,000,000 yearly revenue, and in the future, when these federal timber and mineral reserves will be even more valuable, this royalty revenue may be many times larger.

After a hundred and fifty years of alienation of the public domain, a reverse tide has recently set in. Not only is the federal government holding fast to the 400,000,000 acres of public domain remaining to it, but it is adding slightly to its holdings by buying in or leasing, as an element in the national program of soil conservation, submarginal farm lands. Worse than worthless today, much of this land can perhaps be rehabilitated over a long period.

Disposal of the state domains

The thirty states organized out of federal territory did not have title to the unoccupied land within their boundaries. Rather, the unoccupied land was part of the federal domain, and from it the federal government made grants to the states. For forty years after 1841, each new state entering the Union received a welcome gift of a half million acres of public land. Grants of land in the interest of education were grants to the state governments. Nearly 65,000,000 acres passed into state control through swamp land grants. Each state thus acquired an extensive state domain.

Most of the states recklessly squandered their domains. School lands, intended for a basic support of state school systems, were sold for a song. To be sure, receipts from such sales were usually placed in "school funds," but all too frequently the state treasuries immediately borrowed the cash resources of these school funds, often to finance current expenditures. In return the state governments acknowledged "permanent debts" in favor of their school funds. A few states, among them Minnesota, Montana, and Texas, have by careful sales of their school lands accumulated valuable school funds, but these states are exceptions. State receipts from sales of public land are now fiscally unimportant.

Like the federal government, some of the states have belatedly begun to rebuild their domains. Large areas of land reverted to state and local governments during the 1929-33 depression through tax delinquencies. In New York, Massachusetts, Wisconsin, and some other states, the governmental units acquiring such reverted lands are empowered to convert them into forest preserves and public parks. But in many states legal provision is lacking to give the governmental units clear title. Willy-nilly the reverted land must be restored to private exploitation irrespective of its possibilities of sound economic exploitation, or it must rest suspended in an unsatisfactory no-man's-land between public domain and private property. Fortunately, legislation has been passed in some states to give title to the governmental bodies concerned.

Disposal of other government property

Governments often find on their hands stores of worn-out or obsolete equipment which has a sale value, even if only as junk. The sale of such material brings in a small stream of current governmental revenue. Occasionally, as when the federal government sold off its excess military supplies after World War I, or when it sold Shipping Board vessels during the 1920's, this sales revenue may reach a substantial figure. Such revenues do not usually go into the general governmental treasury, but are earmarked to the department or bureau to which the materials originally belonged.

INVESTMENT INCOME

Policy or accident may make a government an investor and provide it with an investment income. If it operates an enterprise on its own behalf, and if the gross income of this enterprise exceeds the expenses associated with it, the resultant profit is a revenue item for the government. If the enterprise is operated under independent corporate structure, with the government providing all or part of the capital, as in the case of the Panama Railroad, profits will not be covered currently into the government treasury, but will be paid periodically as dividends or accumulate as corporate surplus. Where the government investment is in the form of a loan, long- or short-term, to a public or quasi-public enterprise or to certain lines of private business, the return will take the form of interest. And finally, a government may collect rents or royalties by leasing out properties which it owns.

Enterprise profits and dividends

Problems and issues of government enterprises were discussed at length in Chapter VII, and it suffices here to repeat that profit is not an indispensable requirement of government enterprise operation. Their justification lies in service, the element of profit is incidental. Some few have been or are a heavy cost to the governments behind them. Most, apparently, cover their operating expenses adequately. The confused bases on which their accounts are reported leave it uncertain whether, in addition, they also cover depreciation and obsolescence allowances and interest on the capital invested; the profits they report are probably largely illusory. And occasional "taxless towns" deliberately operate their water systems or electric power plants to produce a broad margin of true profit.

As indicated in Chapter VII, the federal government normally earns no profit on its two principal enterprises—the postal system and the Panama Canal. War emergency enterprises were loss ventures from the outset. Investments in the Panama Railroad, the federal home loan banks, and the federal savings and loan associations are earning dividends. Whether the other credit enterprises

of the federal government will yield dividends or involve the Treasury in capital losses remains for the future to show; as of June 1941, HOLC, Commodity Credit Corporation, U. S. Housing Authority, and the production credit corporations reported net deficits on their capital accounts, all the other federal corporations, surpluses.

State enterprises, as previously indicated, show little profit, except for the liquor monopolies. From the latter, sixteen state governments obtained over \$50,000,000 in 1938. The enterprises of the larger cities operated generally at a deficit in 1938, in contrast to the \$200,000,000 profit reported for all municipalities in 1932. With the exception of the liquor monopolies, the generalization can be made that state and local enterprises for the most part are not a source of income for the governments that operate them.

Interest on investments

Between April 1917 and November 1920, the United States lent its war allies \$9,500,000,000. Within the next year or two, most of the debtor governments fell into default both as to interest and instalments of principal, and were insisting on refunding arrangements at milder terms than the original loan contracts. As finally negotiated, the refunding agreements established a total foreign debt to the United States of \$11,700,000,000, covering original principal and accrued interest to the date of refunding. Interest rates for the future were graduated—lower for the near future than for later years when, it was anticipated, ability to pay would be greater. The more insistent bargainers among the debtor governments won big concessions in interest rates; the agreement with Italy provided for an average rate of four-tenths per cent, the Yugoslav agreement for a one per cent rate, and the French arrangement for a 1.6 per cent rate, while England and most of the other debtors were to pay 3.3 per cent.

Before the funding agreements had all been negotiated, various of the debtor countries had already paid \$670,000,000 in interest. They paid another \$1,300,000,000 after funding until the Hoover moratorium of 1931. With the exception of modest payments by

Finland and Greece, interest payments on the foreign debt ceased with 1931. Most of the debtor governments continued to acknowledge their obligations and expressed a willingness to pay "when, as, and if."

During the past half decade, the federal government has lent immense sums to domestic interests. In 1929 federal funds established a \$500,000,000 revolving fund to cover loans to farm cooperatives. When the system of banks for cooperatives was established in 1933, that fund was closed out. The federal government still has outstanding substantial direct loans to farmers for seed and for relief in stricken areas which bring in a moderate interest. And the Treasury receives interest on its holdings of RFC notes.

With the exception of the Dakotas, the state governments have no loans outstanding on which they receive interest. Indeed, most state governments and practically all local governments are forbidden by state constitutional provision to extend their credit in aid of any outside enterprises. But most state and local governments maintain sinking funds for the retirement of their funded bond issues,² or are charged with public funds for charitable or other public purposes. These funds are invested in interest-yielding securities. As of 1938, state governments were receiving over \$90,000,000 of interest annually, of which a major part was attributable to investments. Municipalities receive between \$60,000,000 and \$80,000,000 of investment interest annually. The usual practice is to invest all or a large part of such funds in the debt issues of the governmental unit maintaining the fund. Consequently, the interest credited to these funds does not always represent a net receipt from outside sources, but rather is a bookkeeping transfer of governmental funds from one account to another.

Interest on deposits

Exact correspondence between the independent rhythms of a government's flow of income and its flow of expenditures is impossible. Unless a government operates on the basis of a permanent surplus balance or deficit balance, there are periods in the fiscal year when

² See p. 677 of this volume

it must borrow on a short-term basis, and there are other periods when it has substantial funds on hand. Cash balances are kept on deposit in commercial banks. Formerly, banks were inclined to look upon these deposits as political plums, and paid no interest upon them, particularly when they were made by local governments. During the prosperous 1920's, when state and local bank deposits were exceptionally large, the principle was generally established that these deposits should earn interest. In a number of states the point was embodied in legislation. Before depression reduced both deposits and interest rates, the state governments and cities with populations over 30,000 were receiving from \$30,000,000 to \$40,000,000 a year from this source.

Even in periods of deficit financing, the federal government traditionally maintains a large working "cash balance." A small part of this balance is deposited with the federal reserve banks, most of it with several thousand commercial banks.³ From 1913 to 1933, 2 per cent interest was paid on all federal deposits; in 1930 this item amounted to over \$3,000,000. When the Banking Act of 1933 forbade federal reserve member banks to pay interest on demand deposits, the Treasury waived interest on its own accounts.

Rents and royalties

Until recent years, rents were generally ignored as a source of governmental revenue. Sinking funds and public trust funds might be invested partly in rent-producing properties, but such rent was hardly a direct current revenue of governments themselves. Docks and wharves were city property in a few of the larger seaboard cities, and New York, Philadelphia, and Boston received several million dollars annually in rents from this source, but these were exceptional cases. Construction companies were allowed free use of the streets—city property—for storing their materials during the construction of buildings. Banks, stores, and business houses built extensive vaults under city streets, under permit of course, but without charge. Under the pressure of revenue needs during the 1920's local governments carefully examined all phases of their governmental

³ See p. 128 of this volume.

activity to seek out additional sources of revenue. Many ended the free granting of street privileges, and charged rental. Cities with populations over 30,000 derived \$24,000,000 from rent on such street privileges in 1930; Chicago alone received \$6,508,090.

State governments ordinarily have little rentable property. In the Dakotas, however, foreclosure on state farm loans⁴ has made the state governments landlords of many farms operated by tenants. Total state rents in 1938 amounted to \$27,000,000.

Federal receipts from rented buildings and facilities are trifling. But contained in the reserved federal domain are valuable mineral and oil deposits, timber stands, and water-power sites.⁵ While most of these are being held in reserve for the future, some are currently leased for private exploitation. In 1927 mining royalties under these leases amounted to \$6,700,000, oil and gas royalties to \$11,300,000, and timber royalties to \$5,200,000. Current receipts from these sources are considerably lower.

GOVERNMENT MONOPOLIES AND LOTTERIES

Government monopolies and lotteries are not uncommon features in the revenue systems of several foreign countries. Government monopolies have never had any place in American public finance. During the nineteenth century, Louisiana and one or two other states sought to develop state lotteries. The principle of government lotteries proved repulsive to the American conscience, and the projects were dropped. State and municipal lottery projects were frequently discussed during the Depression, but the subject did not progress beyond the discussion stage.⁶

SERVICE AND LICENSE FEES

As was indicated in Chapters II and XII,⁷ the primary benefit derived from governmental activities is general and public, and

⁴ See p 191 of this volume

⁵ See p 600 of this volume.

⁶ See Tax Policy League, *Tax Bits*, Vol I, No. 12, October, 1934,

⁷ See pp 34 and 283 of this volume,

cannot be apportioned among individuals. But supplementary individual benefits attach to many of these functions. Thus juries are provided for litigants as part of the general judicial system—but each jury helps decide a dispute between particular sets of litigants. Or, a governmental unit may be compelled to undertake a regulatory function to protect the community against the shortcomings of some particular set of individuals. For example, a municipality must incur the expense of periodically inspecting barber shops because, in the absence of such inspection, some barbers would not maintain minimum public health standards in their establishments.

What could be more reasonable than the assessment of some part of the cost of a governmental function to individuals who derive special supplementary benefits from it, or who occasion the functions? For many functions, of course, the individuals who derive supplementary individual benefits or who occasion the activity cannot be isolated from the general public. There is no means by which the federal Department of Commerce can determine the particular business firms which profit by its reports on foreign markets for American products. And then, for many “social” functions of government, the individuals who derive a particularized benefit are manifestly unable to pay for it—their very poverty gives rise to the function. But very often, the special beneficiaries or the people who necessitate a function can be readily identified—or can be made to identify themselves by the requirement of a license—and a special charge can be imposed. A litigant can be required to pay a service fee for filing each legal document essential to his case and for the jury which sits on the issue. A fisherman who benefits from a state’s fish-protective and fish-stocking expenditures can be made to pay a license fee. So can a barber whose occupation necessitates a municipal inspection service.

Service fees

A service fee is a charge by a government to defray the cost of an administrative service or function which confers a supplementary

special benefit upon individuals.⁸ A definite *quid pro quo* relationship is present—individuals receive a particularized benefit from a government activity and they pay for it. Examples of federal service fees are those attached to federal court procedure, to consular services, and to the issuance of letters patent. State and local governments charge fees in connection with court procedure, for the recording of legal titles and transfers, for examinations in connection with regulated professions and trades, and for a multitude of other varied services.

Service fees bear a close resemblance to the prices and rates charged by government enterprises.⁹ Both involve a *quid pro quo* relationship between a government agency and individuals, and in both cases the payment is made when a specific service is performed by some government agency. The distinguishing feature is the nature of the service rendered. An enterprise price is the rate charged for commodities or services of an *economic* character—for units of water, or gas, or electric power, or transportation, or credit. Service fees are charged for services of a *governmental* or *administrative* character—for elements of court procedure, for the filing or recording of legal documents. But the distinction between the two types of charges is not hard and fast, and there are borderline cases. If a city maintains a municipal college and charges "fees" for registration and for some of the courses, these payments could be freely interpreted either as enterprise charges or as service fees.

The line between service fees and taxes is sometimes hard to draw. A legal act which might provide a basis for a service fee—

⁸ Definitions of "fees" are as many as there are writers who have given attention to the subject. Some ignore the supplementary character of the individual benefits involved. Others include the qualification that the revenue from the charge must not exceed the cost of the service if the charge is to be called a fee. Still others include the stipulation that the revenue from the charge must be earmarked to the service or function to which it is attached.

Inclusion of the term "supplementary" in our definition is necessary to tie it up with the discussion of principles of governmental activity in Chapter II. The relation of fee and charge revenues to costs and the issue of earmarking fee and charge revenues are discussed in the pages following. But since they are issues, they can hardly be elements of a definition.

⁹ See p. 177 of this volume.

the recording of land transfers, for example, or the legal authorization of the transfer of the estates of decedents—can also be made the legal “subject” for a tax. Since taxes are so frequently justified on the “benefit” principle, the *quid pro quo* relationship between governmental agency and individual is not an absolute touchstone to determine whether the charge is a tax or a service fee. Many writers would differentiate on whether the charge produces a net revenue over the cost of the service—if it does, the charge is a tax, if not, it is a service fee. But this is not a sound basis for differentiation because, as we shall see, it is uncertain whether revenues derived from a service charge should be measured against the cost of the particular service or against the cost of the general governmental function behind it. At best, we can say that most service charges can, by all standards, be clearly labeled fees or taxes, but that some fall in a no-man’s-land between the two.

Should the revenue derived from a service fee be measured against the cost of the particular service to which it is attached, or against the cost of the general governmental function of which the particular service is but one detail? Most fiscal economists, apparently, take the narrower view. A service fee, they say, must not produce a revenue greater than the cost of the particular service involved; otherwise it is no longer a fee but a tax.¹⁰ Were this view applied strictly, however, most legal fees would not be fees at all, for with few exceptions the charge far exceeds the unit cost of filing and listing court documents. The same would be true of the federal consular fees.

A sounder view, perhaps, is that frequently taken by legislatures. Service fees are established considerably in excess of unit cost so that the fees contribute to the cost of the general function behind the service. After all, the filing and listing of court documents is but an incidental element of a judicial system. If we are looking for supplementary special benefit to litigants, we have in mind the benefit yielded by the judicial structure, not the incidental service. Why should not the costs of the judicial system be con-

¹⁰ Note that this position was taken in the first edition of *American Public Finance and Taxation*

sidered in their entirety when the schedule of service charges is established? Many service charges have been fixed with this consideration in mind, and it is caviling to deny them the name "service fees."

License charges

If the special supplementary benefits of a governmental function accrue indirectly to a definable class of people instead of directly to individuals through the rendering of some specific service, the service fee cannot be employed. Nor can it be used where a government is seeking reimbursement for a special regulatory expense caused by some definable class of people or some type of business. In such cases the activities which cause or benefit from the governmental function may be made illegal except upon government grant of license or permit, and a charge—a *license fee*—can then be levied on the license or permit.

Examples of the "class benefit" license fee are fishing license fees, the revenue from which goes to support state fish hatcheries, and hunting license fees, the revenue from which supports state game preservation activities. Examples of the "group cost" license fee are restaurant license fees whose revenue is applied to the cost of periodic restaurant inspection to insure maintenance of proper sanitary standards, oil inspection fees, poolroom license fees, and license fees covering the expenses of inspecting elevators in apartment houses and business buildings.

No confusion could possibly arise between license fees and enterprise charges. But the line between license fees and taxes is even harder to draw than that between service fees and taxes. The *quid pro quo* relationship does not stand out as clearly in license fees as in service fees. And the license requirement is a very common instrument of tax administration.¹¹ Our best point of differentiation is the relation between revenue derived and cost of the function involved. If the revenue does not exceed the cost, we may call the charge a *license fee*. If a substantial revenue surplus results, the charge is a *license tax*.

¹¹ See p 524 of this volume.

License fees sometimes evolve into license taxes. When a class of individuals, compelled for regulatory purposes to take out licenses, becomes more or less coextensive with a group specially benefited by some general activity of government, a tax may warrantably be attached to the licensing procedure in accordance with the "benefit" principle of taxation. Thus it was early realized that motorists, who were compelled to license their automobiles as a matter of public safety, were specially benefited as a class by the road-building activities of state and local governments. The motor vehicle license charge, at first merely a fee to cover the cost of recording the license and issuing license plates, evolved into the productive motor vehicle license tax of today. Or again, a class subject to a license tax may be a business group making sales to so broad a class of consumers that a charge levied on them can be passed on to the general public as an indirect tax. Such a circumstance is an opportunity rarely ignored by a legislature hard-pressed to find sources of additional revenue. Thus liquor license charges, originally levied as fees to cover the inspection of saloons, developed into license taxes and became a fruitful source of revenue for state and local governments.

Revenue considerations

Service and license fee revenue is a relatively insignificant element of income for the federal government, but it is an important item in state and local budgets. Although specific statistics are not available, we may fairly assume that service fee revenue accounted for most of the \$186,000,000 reported by the states in 1938 as "charges for current services" and for most of the \$250,000,000 to \$300,000,000 so reported by local governments. And probably some part of the \$1,236,000,000 "license and permit" revenue reported by state and local governments in 1932 was derived from license fees as well as license taxes. On the basis of this calculation, service and license fees are a major source of revenue for state and local governments.

Nevertheless, fees—particularly license fees—are relatively neglected as a state and municipal revenue source. Every survey of city finances discovers occupations and types of business enterprise

which cause the city extra expense in waste removal, street cleaning, police protection, or supervision in the interest of public health or morals, but only a minority of occupations and enterprises are subjected to license fees. Careful study of municipal activities to determine the special costs caused by particular occupations and enterprises, followed by the enactment of license fees to cover the special costs involved, would be of considerable aid in lowering city tax burdens. As an example of the possibilities of expanding the state fee systems, thirty-one states provided in 1933 that public utilities should be subjected to fee charges to cover part or all of the costs of their regulation.

Service fees are frequently attached to particular governmental offices instead of being payable into the general treasury. The practice is to be utterly condemned. As the population of a community grows, there is always the danger that the fees attached to an office will increase out of all proportion to proper compensation for its incumbent. Where large cities have developed within counties, the fees attached to the offices of sheriff and county clerk sometimes run into tens of thousands of dollars; upon occasion they have exceeded the hundred thousand dollar mark. Such an office necessarily becomes an object of political sale, and any candidate aspiring to it must promise a large share of the proceeds to his political party. The fees attached to the office become a source of *party revenue* instead of *governmental revenue*. As for the officials who retain the fees they receive, they are inclined to concentrate on their fee-producing activities, and ignore their other duties. Despite the disadvantages of attaching fees to offices, the influence of political parties anxious to retain party "plums" has prevented thorough-going reform of the fee system in local governments.

SPECIAL ASSESSMENTS

Special assessment has been defined as "a levy to defray the cost of a particular public improvement," and is theoretically in proportion to, but never in excess of, the resulting benefit accruing to the

property against which it is levied¹² This species of special charge is levied principally to finance the opening and improving of highways and streets, the laying of sewers and piping, and the development of parks.¹³

Application

In the United States, the earliest recorded application of special assessment was in the province of New York in 1691. Not until 1813, however, was the principle of special assessments recognized by American courts. Twelve states permitted the levy of special assessments by 1850, and twenty-seven by 1875. Either constitutionally or by statute, all states now permit local governments to levy special assessments, though many states place various restrictions on such assessments.

Special assessments were formerly a major item of city revenue. Only 11 of the 310 cities with populations over 30,000 did not levy special assessments in 1930. Prior to the 1929-1933 recession, municipalities derived a quarter of a billion dollars annually from assessments for capital projects. After 1932, the financial difficulties arising from weak administrative organization and from the decline of the real estate market virtually put an end to special assessment revenue for many cities. Cities with populations over 100,000 reported only \$31,000,000 from special assessments in 1938, as against \$147,000,000 in 1931.

According to the United States Bureau of the Census reports, about half the state governments, chiefly in the South and West, derive a considerable revenue from special assessments levied for

¹² A. R. Burnstan, *Special Assessment Procedure* (Special Report of the State Tax Commission, No. 1, Albany, 1929), p. 9.

¹³ Some writers include as special assessments (1) charges for the abatement of nuisances, as when a city removes snow from the sidewalk before a private house, (2) charges for the improvement to public appurtenances to private property, as when a city paves the sidewalk in front of a private house, and (3) special charges for general public improvements or services levied against the benefited districts, as when a state builds a highway, divides the territory around it into road districts, and levies a tax in each district to finance the construction and maintenance of its section of the highway. The first two are covered under our heading "property benefit charges." The third is more properly viewed as a tax levied in a special governmental unit.

highway construction and maintenance. The Census Bureau, however, classifies as special assessments the taxes levied by these states in special road districts. But the wisdom of this classification is doubtful since the legal and economic incidents of special road taxes differ markedly from those of true special assessments. The special assessment as such has no established place in state revenue systems.

Nature

In contradistinction to a service fee, which is a charge against the individual, a special assessment is a charge against property regardless of ownership. Sometimes a further distinction may be made between the activities which the two classes of charges are intended to compensate. Service fees are commonly charged for administrative and legal services and to cover the costs of a continuing regulatory activity. Special assessments are levied for one purpose only—to compensate a governmental body for its expenditures in creating or maintaining a material improvement.

A special assessment is differentiated from a tax in that the latter is levied to finance governmental functions of general social benefit, while the former is imposed to cover special supplementary benefits accruing to the property of individuals. Furthermore, a tax is levied upon a general class of individuals, properties, businesses, or other subjects, and may have bases other than property, while the special assessment is levied upon a special group of properties. Further, a tax may take into consideration the "tax-paying ability" of the persons upon whom it is levied, whereas a special assessment must be strictly proportional to the benefits accruing to the parcels of property.

While the levy of a special assessment is undoubtedly an exercise of the sovereign taxing power, it is a limited exercise of this power, and subject to certain restrictions which do not apply to taxes. (1) In many states governmental expenditures financed by special assessments must be approved by a referendum of the owners of the property to be assessed. (2) A governmental activity financed by a special assessment must be of direct monetary advantage to the property to be assessed. That it adds intangible values to the lives of

those residing in the district is insufficient. It must add dollars and cents to the value of their property (3) Special assessments are generally based solely on land values, and the value of improvements on the assessed property and of the owners' personal property is not taken into consideration. (4) A special assessment on any particular parcel of land must not exceed the value added to the land by improvement.¹⁴ (5) The total amount of a special assessment must be distributed among the various parcels of land proportionally to the monetary benefit each derives.¹⁴ (6) Finally, in most states a special assessment cannot become a personal liability on the owner of the land; it exists solely as a charge on the land. Land can be sold to cover a special assessment, but a landowner who sells his land subsequent to a special assessment cannot be reached by the levying government.

Special assessments are most commonly levied in a lump sum to finance all or part of the cost of a capital improvement. Where the capital project is extensive and costly, it is not unusual for it to be financed by special assessment bonds, and the special assessment is levied annually on the benefited properties until such time as the bonds are retired.¹⁵ Current governmental activities benefiting a limited district—such as caring for the lawns of a boulevard—are sometimes financed by an annual special assessment. Occasionally special assessments are levied for the repair of improvements originally constructed by special assessments; opinion is divided on the propriety of this practice.

Assessment

An issue arising at the very outset of a special assessment project is the extent to which the cost should be borne by adjacent property owners and the extent to which it should be financed out of general tax funds—or, in other words, how the general social benefit

¹⁴ The courts have relaxed these two rules somewhat, and will uphold a special assessment levied according to one of the well-recognized rules of apportionment, even where, because of special circumstances, the charge on some particular parcel of land exceeds the resulting increase of selling value or is slightly more burdensome than on other parcels of land.

¹⁵ Note that such bonds are frequently exempted from constitutional and statutory limitations on local borrowing powers, see pp 631-633 of this volume.

and special individual benefit of a project should be apportioned. By what fraction does the paving of a street benefit the property fronting on it, and by what fraction the general traffic system of the city? To what extent does the creation of a park generally benefit the entire city, and to what extent does it specifically benefit surrounding property?

No hard and fast rule exists for specifically determining the beneficiaries of such improvements. Street cutting and paving, it was formerly assumed, benefited only the owners of property fronting on the street. Now it is generally recognized that most public improvements carry both a general and a special benefit, and the cost is divided between the owners of adjacent property and the general body of city taxpayers. Legislative authorization of special assessment levies by cities sometimes provides for a specific apportionment of the costs of particular improvements between special assessments and general tax funds. In other cases, the division of costs is within the discretion of some city board. Distribution of costs between the city and benefited properties in New York City is separately determined for each assessment, and formerly resulted in much favoritism and graft. Either way, of course, the division of costs is certain to be highly arbitrary. Engineers have no yardstick by which to apportion accurately the general and special benefits of public improvements.

The next problem is to determine the radius of special benefit for the particular improvement contemplated. Such radius of benefit depends on the nature of the improvement. All property within a quarter or a half mile may be benefited by the creation of a public park or playground. Building an arterial sewer or a boulevard may benefit property for a few blocks on either side. Paving an isolated side street may be of special benefit only to the fronting property. Where the area benefited by an improvement is extensive the special assessment district must be divided into zones, a relatively greater part of the cost being apportioned to the nearest zones, and a smaller share to those more distant.¹⁶

¹⁶ A sample special assessment zone map is reproduced in Appendix H, p. 850 of this volume.

Once the area and zones of the special assessment district have been determined, the costs must be allocated to individual properties. The ideal, of course, but one difficult of attainment, is the allocation of these costs in proportion to the special benefit derived by each parcel of land. Three methods of allocating special assessments among individual properties have been developed: (1) the frontage rule, (2) the area rule, and (3) the depth curve rule. Most common is the allocation of special assessments by street frontage, which discriminates in favor of deep properties and against shallow ones and cannot take lot irregularities into account. Allocation of special assessments by area fails in the opposite direction. While a deep lot benefits more than a shallow one from a street or other improvement, such special benefit is not strictly in proportion to depth. Several cities have sought a middle road out of these difficulties by the use of "depth curves" similar to those employed in property tax assessment.¹⁷ This amounts to zoning individual lots on the basis of some standard lot depth. A specified value is determined for frontage with a given lot depth, a higher value (but not a proportionately higher value) for frontage with a greater lot depth, and similar higher values for stated greater depths. Thus in Denver each lot is divided into 25-foot zones; 35 per cent of the unit frontage benefit is allowed for the first zone, 25 per cent for the second zone, 17.5 per cent for the third zone, 12.5 per cent for the fourth zone, 7.5 per cent for the fifth zone, and 2.5 per cent for all property over a depth of 125 feet. In Arkansas and California the attempt has been made to allocate special assessments by the assessed value of land for property tax purposes. Property tax assessments, however, are notoriously unequal,¹⁸ and using them as a basis for allocating special assessments augments this initial injustice.

Payment

When a special assessment is small in proportion to the value of the property affected by it, payment is easily arranged. While the improvement is under construction, the property owners can pay

¹⁷ See p. 376 of this volume

¹⁸ See p. 380 of this volume.

the assessment in one or more cash instalments. Funds are thus currently made available for paying the costs of construction. Many of the more recent improvements for which special assessments have been levied, however, have been extensive undertakings. Work upon them has extended over several years, and any lump-sum assessment payment would have disrupted the private finances of the property owners affected. Consequently, many of these special assessment projects have been financed by bonds paid off by annual special assessment levies over a period of years.

In some states, special assessment bonds would come within the city's debt limitation were they a charge on its general credit. To avoid limiting borrowing power, cities have experimented with a number of expedients. Special assessment bonds have been issued as charges on the benefited property without being obligations of the cities of issue. Lacking city credit behind them, these bonds proved expensive to market. Occasionally, the contractor engaged upon the improvement was required to accept such bonds in payment. In such cases, the contractor calculated a collection premium on the bonds, and added it to his costs of construction.

Other cities have provided "revolving funds" to finance special assessment improvements. Costs of the improvement are paid out of such funds, which in turn receive the special assessment bonds issued on the benefited property. But revolving funds have proved susceptible of political manipulation, and have permitted irregularities to exist and accumulate undetected because the actual levy of the assessment is often postponed until long after the improvement is completed.

A third possibility, strongly recommended by authorities on special assessments,¹⁹ is the issue of assessment bonds purely as charges on the benefited property, but guaranteed by the city. Such bond issues do not ordinarily come under the borrowing limitations imposed on municipalities. According to the proponents of this arrangement, default on such bonds would be very small, so that the

¹⁹ See *Burston op cit.* p. 89

cities would be assuming no great obligation, while their guaranty would hold down the interest rate. But during the depression of the early 1930's no bond issues went so readily to default as special assessment issues²⁰. Many municipalities which had guaranteed special assessment bonds discovered their guaranties coming home to roost at the most inconvenient time. Municipal underwriting of special assessment bond issues is not an obligation to be undertaken lightly.

Conclusion

Special assessments are and should be an item of major importance in the finances of growing communities. They must decline in importance when a community has achieved its mature growth and has completed a reasonable program of establishing parks and boulevards and cutting and paving streets. Since many American cities probably have decades of growth ahead of them, the problems of special assessments will long remain to trouble city administrators and students of Public Finance.

Outstanding is the problem of devising some machinery of control over the initiation of special assessment improvements. Too often, a "shoestring" real estate operator interested in developing some semisuburban section prevails upon a city council to install an expensive set of improvements—graded and paved streets, sewerage, and water systems—long before settlement in the area is sufficient to warrant such undertakings. Installation of the improvements helps sell the operator's lots, of course. If the developed area is sold entirely to householders, assessment payments will probably come through as anticipated. But if, as happens all too often, the operator's dream never materializes and the development never shows more than a scattered handful of homes, the special assessments to finance the improvements are bound to encounter difficulties. The operator gracefully takes refuge in bankruptcy, the city acquires some worthless bare lots by tax delinquency foreclosure, and the costs of the improvements must be met out of general revenues.

²⁰ See p. 673 of this volume.

under power of eminent domain, escheat, gratuities, fines, forfeitures, and penalties. By sovereign rights delegated by the states, the local governments may obtain revenue from expropriation under eminent domain, from subsidies, from fines and penalties, and from gratuities.

Tribute and subsidy

Tribute, a major item in the fiscal systems of ancient governments, is the payment exacted by a conquering government from a conquered government. Under the polite term "war costs" it played an important role in the finances of the Allied and American governments during the 1920's. The Dawes Plan, as modified by the Young Plan, provided that the American government should receive an annual tribute from Germany as reimbursement of the expenses of the American army of occupation, calculated at \$292,663,436. Germany paid 55,000,000 reichsmarks annually from 1926 to 1929, 25,300,000 reichsmarks annually from 1929 to 1931. These payments were suspended under the Hoover moratorium of 1931. A "moratorium agreement" in 1932 provided for a new, reduced schedule of payments. But in 1933 Germany arbitrarily stopped paying tribute. Thereafter, the American government continued to assert its claim to these payments, the German government passively ignored such claim.

Prior to the nineteenth century, strong European powers not uncommonly subsidized rulers of the small principalities dotting the map of Europe. In return, subsidized princes were expected to aid these powers when they engaged in wars. Such subsidies somewhat resembled tribute, but were to be distinguished from it in that the payments were voluntary instead of compulsory.

The United States has neither paid nor received subsidies of this sort, if the aid accorded by France to the Colonies during the Revolution be excepted. A system of internal subsidies, however, has developed in this country. The federal government distributed some \$700,000,000 of "federal aid" to the state governments in 1937, largely for relief purposes; in 1940 its "aid" payments were \$1,539,000,000. State governments distribute over a billion dollars of "state aid" an-

nually to their local governments. Federal aid from the viewpoint of the state governments, and state aid from the viewpoint of the local governments, may be considered subsidies received from other governmental bodies. By these payments, the federal government persuades the state governments to undertake certain activities they might not otherwise undertake, and to make these activities conform with federal standards.²³ Through state aid the state governments purchase a similar control over local activities²⁴ As for the finances of the United States as a whole, it should be noted, federal aid and state aid neither add nor subtract from the total of American governmental revenues, since they are transfers entirely within the family of American governmental units.

Currency privilege

Minting metallic money in the United States is the exclusive prerogative of the federal government. Since the bullion value of all silver, nickel, and copper coins is less than their face value, the Treasury makes a profit on every coin issued from the mints. On each silver dollar minted or silver dollar certificate issued against silver held in the Treasury the profit at present silver prices is around sixty cents; on silver subsidiary coins it is slightly more. Coinage profits in 1940 amounted to nearly \$100,000,000.

The currency histories of the American colonial governments from 1690 to 1763, of the Continental government during the American Revolution, of the Union and Confederate governments during the Civil War, and of several of the European countries during and after World War I, indicate that the right to print paper money can be made a major source of national governmental revenue, at least for a short period. When all other sources of revenue fail, a government can pay for the materials and services with paper money issued as rapidly as its printing presses can turn out. An English writer has commented upon the issue of paper money as a fiscal expedient as follows:

²³ The principles and practice of federal aid are considered in more detail on pp. 760 ff of this volume.

²⁴ The principles and practice of state aid are considered in more detail on pp. 733 ff of this volume.

This method [of obtaining governmental revenue] is condemned, but its efficacy up to a point must be admitted. It is the form of taxation which the public find hardest to evade and even the weakest government can enforce, when it can enforce nothing else . . . The burden of the tax is well spread, can not be evaded, costs nothing to collect, and falls, in a rough sort of way, in proportion to the wealth of the victim . . . Like other forms of taxation, these exactions, if overdone and out of proportion to the wealth of the community, must diminish its prosperity and lower its standards, so that at the lower standard of life the aggregate value of the currency may fall and still be enough to go round. But this effect can not interfere very much with the efficacy of taxing by inflation . . . It is evident that so long as the public use money at all, the Government can continue to raise resources by inflation. Moreover, the conveniences of using money in daily life are so great that the public are prepared, rather than forego them, to pay the inflationary tax, provided it is not raised to a prohibitive level . . . Recent experience everywhere seems to show that it is possible to inflate 100% every three months without entirely killing the use of money in retail transactions, but that a greater rate of inflation than this can only be indulged in at the peril of total collapse.²⁵

Currency inflation soon wrecks national credit and ruins broad classes of the country's population. But to the extent that a national government is willing to pay this price it can temporarily convert its currency right into a revenue source with a substantial yield.

In 1933 and 1934, the American government disclosed still a third method whereby a national government's monetary power may contribute to its Treasury. Between March 1933 and January 1934, as a means of stimulating a general increase of prices, the Roosevelt administration devalued the dollar by slightly more than forty per cent—by the Gold Reserve Act of 1934, the gold content of the dollar was set at 15 5/21 grains .9 fine, as against the former standard of 23.22 grains. On April 5, 1933, a presidential order "nationalized" all gold in the United States—ordered the delivery of all privately held gold coins and bullion to the Treasury. When the Gold Re-

²⁵ J. M. Keynes, *Monetary Reforms* (Harcourt, Brace and Co., New York, 1924), Ch. II

serve Act of 1934 officially made gold worth \$35 an ounce instead of \$20.67 an ounce, the federal Treasury netted a capital gain of \$2,808,000,000 on its gold holdings.

Expropriation under power of eminent domain

Governmental necessity prevails over private right. Therefore, when a government needs a particular piece of property for public purposes, and that property is owned by an individual or a private corporation, the government can appropriate it under its sovereign power of eminent domain. The federal government, the state governments, and the local governments all possess this power.

This expropriatory power can never be a source of profit to a government in the United States, because constitutional provisions compel the expropriating government to reimburse the expropriated individual. Further limiting the power of eminent domain is the requirement that the expropriation be for a public purpose. The compensation of the individual may be determined either by contract with the expropriating government, or by the courts in cases where no agreement can be reached.

Escheat

The ultimate title to all property, real and personal, is in the State as sovereign. Only because the State waives that right can individuals claim to have any title. Only by provision of law can an individual transfer his title in property to another. When the title of individuals fails for any reason, the title in the property reverts to the State.

Individual title to a property fails only where an individual, not having any heirs within the relationship provided by law for intestate inheritance, dies without making a will. Intangible personal property then reverts to the government of the state of his domicile, and real property and tangible personalty to the government of the state wherein they are located, since ultimate sovereignty as to property and property rights inheres in the state governments.

Few individuals die without heirs capable of inheriting under the liberal inheritance laws of this country. Were such a contingency

probable in the case of a wealthy individual, he would be almost certain to provide for the disposal of his property after his death by a will. The state governments derive an annual revenue of but one to two million dollars from escheats.

City governments receive a small revenue from the so-called "escheat" of the property of persons who have disappeared and cannot be located. By virtue of power delegated to them by the state legislatures, the city governments take title to such property.

Fines, penalties, and forfeitures

Crimes and infractions of the public laws are punished by imprisonment or fine, and sometimes by forfeiture of property involved in the crime. Breaking bail forfeits any bail bond. Such punishment visits retribution on the offending individual, and in addition, fines, penalties, and forfeitures contribute to governmental revenues. These items yield the federal government an annual revenue in excess of ten million dollars. The state governments receive from five to ten million dollars, and the municipalities around twenty million dollars, annually from this source.

The fiscal aspect of fines and forfeitures, of course, should never be otherwise than secondary, since the endeavor to derive a sizable governmental revenue from fines leads to miscarriage of justice. Nevertheless, it is not an uncommon practice for villages located along main-traveled highways to establish "speed traps," mulcting the unwary motorist on the excuse of his having exceeded a local speed limit. Some "speed trap" governments boast that the revenue they derive from such fines has enabled them to forego all local taxes. It is needless to add that there can be no approval of such practice.

Gratuities

Governments rarely receive gifts or bequests solely for the purpose of aiding them in carrying on their ordinary governmental activities. Instead such bequests and gifts are made to them as trustees for some public and charitable purpose. Gifts to governments for schools, libraries, and museums are common.

PART IV

GOVERNMENTAL BORROWING AND
INDEBTEDNESS

CHAPTER XXV

Principles of Governmental Borrowing

BORROWING should be, and generally is, a supplementary expedient of governmental financing. Continual borrowing and a permanent increasing debt, as we shall see, are fiscal possibilities. But by and large, the greater part of governmental expenditure must in the long run be financed out of taxes and other current revenues. Ultimately, all indebtedness is—or should be—redeemed with funds derived from current revenues.

Despite its supplementary character, governmental borrowing raises issues and problems as far-reaching as any connected with the more basic procedures of expenditure and taxation. Every aspect of public credit—the purposes of borrowing, the manner and methods of borrowing, the control of borrowing, the management of outstanding public debt, the economic consequences of borrowing and debt retirement—is a subject of heated controversy. The abrupt increase of American government debt from approximately \$5,000,000,000 just prior to America's entry into World War I to over \$30,000,000,000 by 1920 and the subsequent rise of the public debt from the \$30,000,000,000 level in 1930 to \$69,000,000,000 in 1941 have given added importance to the study of American debt problems.

LAW OF AMERICAN GOVERNMENTAL BORROWING

Like the power to tax, the power to borrow is inherent in all sovereign governments. All American state governments consequently have full inherent power to borrow, subject only to such limitations as they have imposed upon themselves in the federal Constitution and their own constitutions. Although the federal government has only such borrowing powers as are designated in the federal Constitution, by the terms of that document¹ and the construction of

¹ Art I, Sec. 8, § 2.

the courts, these powers are full and untrammelled. Local governments have only such powers of incurring debt as are delegated to them by state constitutions and statutes.

Constitutional limitations on state borrowing

By ratifying the federal Constitution, the states sacrificed only one minor detail of their inherent borrowing powers—they prohibited themselves from issuing debt instruments in the form of “bills of credit” intended to circulate as money.² Borrowing powers of the state governments are, however, sharply restricted in many state constitutions.

During the first half of the nineteenth century, a number of states underwrote the bonds of railroad companies which subsequently failed, leaving the state governments saddled with heavy debts. To prevent any recurrence of such proceedings, amendments forbidding the legislatures to lend state credit to individuals or corporations were written into most state constitutions.

In twenty-two states, bond issues over some specified limit can be authorized only by constitutional amendment. Occasionally the limit within which the legislature can act upon its own initiative is a double one: a low figure for general borrowing and a higher one for some special purpose. Thus the Maine legislature can authorize general loans up to \$2,000,000 and highway loans up to \$36,000,000; the Minnesota legislature cannot borrow for general purposes, but can authorize highway loans up to \$75,000,000. In eighteen other states, bond proposals must be submitted to the electorate by referendum. Sometimes this requirement applies to all proposals, in other cases such submission must be made only for issues which exceed a pre-established constitutional limitation. In the remaining eight states, the legislature has full freedom of action on borrowing. Where limitations are established on the freedom of legislative approval of debt issues, the limitation is generally in the form of a fixed sum. Seven states, however, limit state debt to a specified per cent of the assessed valuation of property within their borders. Borrowings to cover casual deficits and bond issues to suppress insur-

² Art I, Sec. 8, § 10

rection or to repel invasion are generally exceptions from constitutional limitations.

Some state constitutions also cover various terms of state borrowing. Interest on Maine bonds may not be higher than 5 per cent. Minnesota bonds may not be sold under par. In twenty-one states maximum maturities for state bonds are constitutionally established; the maximum period ranges from ten years in Iowa and Minnesota to seventy-five years in California. State constitutions commonly require the legislature to levy a special tax sufficient to cover debt service at the same time that it authorizes a bond issue.

Constitutional limitations on the incurring of state indebtedness have proved irksome to a number of state governments in recent years. Particularly was this true in 1934 and 1935 when a number of states found themselves temporarily unable to obtain federal relief funds because they could not borrow funds to "match" the federal grants. Instead of removing the restrictions, however, special bond issues of specified amounts and terms have been authorized by constitutional amendment. Probably this is the wisest method of handling restrictions on state borrowing powers. Hampering though they sometimes appear, the restrictions are a protection against the squandering of state credit. Whenever a real necessity for incurring a heavy state loan arises it is possible in most states to obtain authorization by special constitutional amendment. The delay and publicity involved in amendment procedure are intended to insure serious consideration of the proposed bond issue. But most state electorates are apparently ready and willing to ratify "loan" amendments.

Constitutional and statutory limitations on local borrowing

Constitutional clauses and legislative enactments creating various classes of local government usually delegate limited borrowing powers to these governments. But this rule is far from universal. New England county governments ordinarily cannot borrow. And many of the special districts created in such numbers in recent years have been given taxing, but no borrowing, powers.

Local borrowing powers are generally regulated in greater detail

than those of state governments. The purposes for which local governments may borrow, the methods of incurring debt, the amount of local debt, its interest rate, its term, provisions for retirement, and the form of local debt issues, are all regulated, in one state or another, by constitutional or statutory provision.

Local governments in a majority of the states are forbidden to lend their credit to corporations and individuals. Otherwise, restrictions as to the purposes of local borrowing are few and unimportant.

The most common limitation on the amount of local borrowing is a provision that the outstanding total of indebtedness must not exceed a specified proportion of the assessed value of property within the borrowing district. Usually, different assessment-ratio debt limits are established for the various classes of local governments. The sharpest limits are ordinarily set for cities, the highest for school districts. This assessment-ratio limitation frequently excludes self-supporting debt,³ city indebtedness for water, gas, or electric systems, and special assessment debt. A majority of states provide that all or certain of their local governments can issue bonds only after approval by a local referendum. A few states permit local governments to exceed the assessment-ratio limits by specified amounts for certain purposes on local referenda.

Such limitations on the total amount of local indebtedness have in many instances proved failures.⁴ Local governments circumvent them by raising the ratio of their property assessments, thus raising their debt limits, or by camouflaging their borrowings as special assessment loans exempt from the general limitation. Some state legislatures have connived with local governments to exceed constitutional debt limits by creating special governmental units to take over particular functions of the original debt-laden government, giving each new unit a new debt-incurring capacity. Illinois, Michigan, and New Jersey present outstanding examples of this abuse.

³ Self-supporting debt is discussed on p. 639 of this volume.

⁴ See Leroy A. Shattuck, *Municipal Indebtedness* (Johns Hopkins Studies, Series LVIII, No. 2, Baltimore, 1940).

Superimposition of governmental districts in New Jersey made possible in some cases a total debt of 30 per cent of assessed valuation despite a 7 per cent debt limit. Some Detroit suburban communities built up superimposed debts amounting to 50 per cent of assessed valuations. Furthermore, local governments which have borrowed up to their debt limits and cannot circumvent them, are often caught in a disastrous fiscal straitjacket, particularly when property values decline as they did during the 1930's.

A number of states fix the maximum interest rate, usually 6 per cent, which the bonds of their local governments can carry. Another fairly common provision is that local bonds must not be sold below par or under a certain discount.

Quite a few states set maximum terms for local bond issues. Usually the term of the bond issue may not exceed the life of the improvement it is intended to finance. Some states specify the maximum bond terms for various purposes, embodying in the statute itself the legislative judgment as to the probable life of various forms of local improvements. Limitations on maturities have also proved of doubtful value. The provision that the loan-term shall not exceed the life of the improvement is directed against irresponsible governments which seek to dodge their fiscal obligations by creating debts of such distant maturity that, as far as the present generation is concerned, the debt is never to be repaid. Unfortunately, local governments too often interpret limitations of this character as authorization to fix the maturities of all their borrowings by the life of the improvements so financed. The period intended by the constitution or statute to be a maximum is taken as a standard by the local governments. As will be subsequently indicated,⁵ this establishes the maturities of local loans on a false principle.

In recent years a considerable number of states have required the issue of local bonds in serial form.⁶ Most states which permit sinking-fund bonds⁶ require their local governments, when issuing bonds, to levy a tax sufficient to cover all debt charges on the issue.

⁵ See p. 669 of this volume

⁶ Serial and sinking-fund bonds are discussed on pp. 677-680 of this volume

Central control of local borrowing

Central control of local finances either by a state agency or by county agencies, described in an earlier chapter,⁷ may be extended to cover review of proposed bond issues as well as of proposed tax levies. The board of review should have the authority to condemn a proposed bond issue and to direct that the intended expenditure be financed from tax funds, if in its opinion, such procedure should appear desirable. It should also have power to modify the maturity and other terms of any proposed bond issue. Local refunding issues are now subject to state supervision in Michigan, Ohio, New Jersey, North Carolina, and Pennsylvania.

To date, the most effective general system of state control of local borrowing has been established by North Carolina.⁸ Proposals for local bond issues must be submitted to the Local Government Commission for approval before either the bonds are issued or the question of issuance is presented at election. Upon receiving the application, the Commission considers the necessity, expediency, and adequacy of the bonds, the financial condition of the applicant, and its ability to pay the proposed bonds. Additional information may be called for and a public hearing be conducted on the question. But the action of the Commission does not deny the right of election, and if carried at election, the bonds may be issued regardless of the Commission's decision.

All bonds are advertised and offered for sale by the Commission at its office at Raleigh. Sealed bids are invited at public sale, and unless a representative of the unit present at the sale objects, the award is made to the highest bidder at not less than par and accrued interest at a rate not exceeding 6 per cent. No bonds are sold at auction.

All bonds sold by the Commission are delivered to the purchaser through the State Treasurer, who collects the purchase price. He then promptly turns his collections over to the local unit's lawful custodian of funds, or deposits them in the unit's depository bank if

⁷ See pp 163 ff. of this volume

⁸ See W E Easterling, "State Methods of Controlling Local Debts," *Proceedings of the Twenty-Ninth National Tax Association Conference*, 1936, pp 417-18.

he is satisfied that the bank has furnished the security legally required for the protection of deposits. In the case of funding or refunding bonds, the State Treasurer may, and usually does, apply the collections directly to the payment of the obligations being funded or refunded.

PURPOSES OF GOVERNMENTAL BORROWING

Borrowing usually merely *postpones* the covering of an expenditure by taxation or other current revenues, borrowing serves as absolute *substitute* for current revenues only upon subsequent direct or indirect default. Not only must the principal of any debt item be redeemed ultimately out of current revenues, but a continuing item of interest is added to the cost of government for so long as the debt is outstanding. Special circumstances must be present to justify the financing of any government expenditure by borrowing instead of taxation or other current revenues.

Authorities on Public Finance have established four fiscal purposes which *may* justify governments in raising funds by borrowing: to finance large emergency or irregular expenditures, to finance capital construction projects, to harmonize the divergent rhythms of current expenditures and current revenues, and to refinance existing debt. Certain nonfiscal considerations may occasionally provide supplementary justification for a government's borrowing policy.

War loans

Outbreak of a war, or "all-out" preparation for an expected war, may be viewed as an emergency justifying a national government in proceeding promptly to loan floatations. The need for heavy military expenditures is immediate. No system of war taxes could be levied and collected quickly enough to provide the funds required by the national government to raise, equip, and maintain a fighting army and navy during the first months of a war. With the present institutional financial organization in the United States, hundreds of millions of dollars of short-term notes and certificates can be sold within a few hours to the special markets for such securities. National investment drives, like the Liberty Loan campaigns of World

War I and the "Defense Bond" drive of World War II, can obtain billions of dollars from individual subscriptions before any sort of tax system could produce its first millions.

But the "emergency" argument for national borrowing does not extend to loans made after the first year of a war. Within a year's time, a tax system geared to produce any desired amount of revenue can be devised and set in operation. If a borrowing policy is continued thereafter, it must seek justification on other grounds than emergency. Arguments aplenty in support of continued war borrowing have been advanced. To the extent that the national government sells its debt issues to financial institutions, or to the extent that individuals purchase their bonds on a "borrow and buy" policy, additional elements of bank credit are injected into the nation's economy. The resulting inflation stimulates productive activity. Heavy taxation, on the contrary, is certain to exercise a depressing deflationary effect, and may crush some vital war industries. Furthermore, war borrowing takes funds which may be conveniently surrendered, while war taxation strikes arbitrarily without regard for individual convenience. Against continued war borrowing are the factors that it adds a heavy item of interest to other war costs, that the resulting inflation increases the costs of whatever the government buys and hence increases the general war cost, that the resulting inflation may generate an unhealthy cyclical swing and lay the ground for a disastrous postwar collapse, that the civilian population is left with an excess of purchasing power that competes with government demand for materials and commodities essential to the war effort, and that too much dependence on borrowing for too long a time may weaken, if not wreck, the government's credit.

No economist of consequence has ever suggested that a government finance war activities of substantial proportions exclusively by borrowing. And few have advocated an all-tax program of *war* finance. General critical opinion favors a combination tax and borrowing approach to war financing, with no agreement whatsoever as to the best proportion between the two. When the United States entered World War I in 1917, the Treasury first proposed the division of war costs half and half between taxes and loans. Later the

proportion was set at one-third and two-thirds. Actually, if the Allied Loans are eliminated from the picture, taxes covered 45 per cent of the federal government's 1917-1918 expenditures, and 28 per cent of those of the following year. General critical opinion is that these proportions placed too much dependence on borrowing. For 1940 and 1941 defense financing, the Treasury set a ratio of two-thirds taxes to one-third borrowing.

"Relief and recovery" borrowing

In 1933 the federal government assumed two new and costly functions: the relief of widespread distress resulting from depression unemployment and "pump-priming" expenditure to stimulate recovery.⁹ Whatever be the judgment passed on this expenditure program, its adoption created a fiscal emergency—a succession of staggering annual deficits—which would warrant classifying federal "relief and recovery" borrowing, at least from 1933 through 1935, in the "emergency" category.

Not only would it probably have been impossible to cover by taxes the billions of dollars spent on relief and recovery during this period, but it would have been economically inadvisable. Heavy taxation would have absorbed nearly as much purchasing power as the federal expenditure was creating, and thus have nullified a major purpose of this expenditure. Borrowing by sale of securities to banks that created funds for their purchase provided the federal government with purchasing power without depriving anyone else of consumption ability. Of course the effect was inflationary, but a moderate inflation was one of the salves which the Roosevelt administration was applying to the economic system.

Other emergency borrowing

When a river overflows its banks and submerges the neighboring countryside, when a tornado cuts a swath of destruction across a populated territory, when an earthquake demolishes a city, the local and state governments affected, and sometimes even the federal government, must make heavy expenditures to repair at least part of

⁹ See pp 73 ff of this volume

the damage and, in the case of floods, to guard against a repetition of the disaster. The outlays demanded may exceed the cash resources at the moment in the treasuries of the affected governmental bodies. Even were special taxes hastily levied to provide the desired funds, there would still be a considerable lapse of time before the receipts were actually available to the levying governments. Moreover, such widespread disaster weakens the financial structure of the communities affected, and heavy taxes would delay recovery. Expediency dictates the remittance of existing taxes for a year or two, rather than an increase in tax burdens. Emergency governmental expenditures necessitated by extensive natural disasters are always properly financed by borrowing.

Frequently enough, state and local governments neglect to keep their institutional facilities, such as prisons and hospitals, abreast of the needs of the times. Unnoticed by the legislature and the public at large, existing institutions become overcrowded and resort is had to obsolete or improvised structures not adapted to present needs. Suddenly a prison riot, a hospital fire which proves a holocaust because the structure turns out to be a firetrap, awakens legislators and the public to the pressing need for new buildings. A system of new prisons or hospitals must be built immediately, and the cost is too great to be embodied in any "pay-as-you-go" program or in any long-term budgeting of capital construction. Though the responsible legislators and administrative officials may be open to censure for having permitted such a situation to develop, the situation itself is an emergency warranting resort to borrowing.

"Emergency" justification may be extended to certain other public borrowings where the expenditures causing them, while not of a strictly "emergency" character, are large-scale and irregular. New York City and a few other cities in similar isothermic locations may experience some winters when snow removal costs only a few thousand dollars, and others when snow costs run into millions of dollars. Under such circumstances, these cities cannot cover snow removal costs in their current budgets. Quite properly they finance heavy snow removals by special intermediate-term bonds. Veterans' bonus payments voted by the state legislatures during the early

1920's, and the prepayment of the federal bonus in 1936, too large to be covered out of a year's current revenues, likewise dictated recourse to borrowing. A similar argument could be advanced for federal borrowing to finance the Treasury's "sterilization" purchases of gold during 1937.

Borrowing to finance government enterprises

To raise the requisite funds for acquiring or creating property, a private commercial corporation which owns and operates a street railway or an electric power plant would ordinarily float a bond issue. While such a bond issue is often technically a mortgage on the corporation's property, its real security is the circumstance that the company's income from charges is more than sufficient to maintain the property in first-class condition and to pay interest on the bonds. If the property backing the bond issue has a limited life, company revenues must in addition be sufficient to accumulate a fund which will either renew the property when it is worn out or redeem the bond issue. There is no reason why a municipality which operates or intends to operate an enterprise in a manner to cover both current costs and capital charges by the rates charged for services, should not imitate commercial public service corporations and finance capital costs by a bond issue. Substantial amounts of municipal "enterprise" debt of this character are outstanding. State "enterprise" debt is relatively unimportant in amount, since the states have not ventured deeply into the enterprise field.

The federal government, as described in Chapter VII,¹⁰ has made heavy "enterprise" commitments. Some, like the postal system, the Alaska Railroad, the Bonneville and Boulder Dam projects, and the reclamation and resettlement projects, are handled through various current departmental accounts, with no special earmarking of the capital costs involved. But to the extent to which these projects have added to deficits or reduced current surpluses at any period, they have indirectly added to the total of federal debt outstanding. Panama Canal construction resulted in a specific debt item of \$135,000,000. And at least \$4,000,000,000 of the \$16,000,000,000 borrowed

¹⁰ See pp 179 ff of this volume

by the federal government between July 1932 and June 1937 supplied capital for the various credit, power, and other enterprises established under New Deal auspices.

Governmental debt incurred for government enterprises whose charges cover interest and principal payments, is commonly called "self-supporting debt." Unlike ordinary governmental indebtedness, it represents no burden on the taxpaying public. State constitutions and statutes generally recognize the distinction, and exempt "self-supporting debt" from many limitations which bind other governmental debt. Sometimes, for social reasons, municipalities prefer to set the service charges of an enterprise so low that the revenue received does not cover interest charges and the retirement of the debt originally incurred¹¹ Or mismanagement may so reduce government enterprise revenues that they do not cover its debt service. In either case, since part of the debt service must be met by funds from the general governmental treasury, such "enterprise debt" is no longer "self-supporting debt." When a government enterprise fails to pay its way, its indebtedness must be considered ordinary governmental debt incurred for a capital item, and be governed by the principles relating to such debt stated below.

Borrowing to finance ordinary capital construction

When a rural school district, embracing perhaps a single elementary school or a combined elementary and high school, decides that its existing schoolhouse is antiquated and unsuited to present needs, and votes to construct a new and larger one, the expenditure involved can hardly be viewed as emergency. The old school building could be continued in use for several years. Sooner or later, however, and the sooner the better, a new schoolhouse will be needed. Were the entire cost of the new schoolhouse thrown into the tax levy of a single year, that levy would be crushing for the taxpayers of the small school district. If a bond issue to cover the cost is floated instead, the taxes necessary to retire the debt can be spread over a term of years. In each year's levy, the increment of the construction cost will be too small to be an irksome burden. Furthermore, tax-

¹¹ See pp. 175 ff. of this volume.

payers ten or fifteen years hence who contribute towards the retirement of the construction debt will be sending their children to the school and so deriving a benefit from it. The same arguments can be advanced in favor of constructing a county hospital, building a town hall, or erecting a state capitol. In general, a capital governmental project of lasting benefit, which will not soon be duplicated by the same government, and whose cost is heavy relative to the financial resources of the community called upon to pay for it, is properly financed by borrowing.

A different set of circumstances is presented by a large city or state with a growing population and a rapidly developing economic and social life. Many capital expenditures of such a city or state are as continuing and ordinary a phase of governmental activity as its current expenditures. Year after year, New York City, Chicago, the metropolitan district of Boston, San Francisco, and other large and growing cities, must expect to build a certain number of new school buildings. Each year too, they must extend their water supply systems, open and pave new streets, and purchase additional fire-fighting apparatus. States like New York, Illinois, Ohio, and Missouri annually require additional prison, hospital, and other institutional facilities. Some of these cities and states do, and all of them could, through moderate foresight, engage upon a program of capital construction which would progress in yearly instalments.

The effects of borrowing to finance continuing capital expenditure of the type indicated above should be distinguished sharply from the effects of borrowing to finance occasional, non-repeated capital projects. In the latter case, the item of indebtedness having been incurred, there follows a long period during which no additions are made to governmental indebtedness. Meanwhile, either the existing debt is reduced by serial retirement, or a sinking fund is accumulated against the time of its maturity. When, years hence, the community borrows for some other item of capital construction, it does so without pyramiding debt service requirements. But, if governmental loans are floated to finance continuing capital expenditure, the process of borrowing must continue year after year. Total outstanding indebtedness mounts, and with it the interest and debt

retirement charges to be met out of each year's current budget. Eventually, because of past borrowings, annual payments for interest and debt redemption equal or exceed expenditures on present capital projects. Such a borrowing policy, moreover, pushes the debt total close to the constitutional or statutory limit, a condition which in the event of an emergency would hamstring a government. All the economic and social evils of governmental borrowing, subsequently considered, are incurred for no laudable purpose.

If cities and states would plan their capital construction projects in long-term programs, as is advocated in an earlier chapter of this volume,¹² they could preplan their capital expenditures in reasonably even instalments. Were capital costs equalized by preplanning, a state or city government could properly adopt a "pay-as-you-go" program and finance each year's quota of capital construction by a tax levy.¹³ The "capital construction" levy would continue unchanged for a considerable period of time because of the uniform budgeting of the government's construction projects. Borrowing powers would be reserved for emergencies, for occasional unavoidable "peaks" of capital outlay over the uniform continuing normal, and for occasional special projects not comprehended in the budgeted program.

Where the yearly expenditure on capital projects varies considerably, a complete "pay-as-you-go" program cannot be applied. Yearly variations in tax rates, necessary to cover varying capital expenditures, would irritate taxpayers, who desire an element of certainty and stability in their tax rates. Widespread adoption of a strict "pay-as-you-go" program to finance continuing capital expenditures is dependent upon the application of budgetary principles to capital expenditure.

But even the states and cities which do not budget their capital expenditures can partially apply the "pay-as-you-go" program to continuing capital expenditures. In the past, the capital expenditures of large cities and states, undertaken without foreplanning and

¹² See p. 139 of this volume

¹³ The techniques of shifting from a borrowing to a partial or complete "pay-as-you-go" program are presented in Carl H. Chatters and Albert M. Hillhouse, *Local Government Debt Administration* (Prentice-Hall, New York, 1939), pp. 375-383

budgeting, have exhibited a cyclical rhythm, swelling in periods of business optimism, contracting in periods of general depression. Suggested earlier in this study¹⁴ was the possibility of a contrary rhythm of capital governmental expenditures, deliberately forced by the governmental bodies themselves to counteract the cycle of general business inflation and depression. Either rhythm of capital expenditure offers a city and state the opportunity to provide a "capital construction" tax levy covering all capital expenditures during the low ebb of its construction cycle, and covering a large part of such construction costs even in the peak years. To determine the amount of such a levy for a five- or ten-year period, a city or state government might review its capital expenditures during the past decade, note the rough outline of their cycle, and establish the "capital construction" levy on the basis of the lowest capital expenditure made. Should the capital expenditures of some year be less than the amount of the "capital construction" levy, the surplus could be paid into the city's or state's sinking fund, or be used to buy its bonds on the open market for direct retirement. A program combining a "capital construction" tax levy to finance the minimum of continuing capital expenditures, with borrowing to cover the excess of capital expenditures over this minimum, is recommended to large cities and states which do not preplan and budget their capital expenditures.

None of the limitations on incurring state indebtedness now embodied in state constitutions would bar any state government from adopting the borrowing program suggested above. Some cities, however, might find that constitutional or statutory provision sets obstacles in their way. For example, it is occasionally provided that every local bond issue must state on the face of the bonds the specific purpose for which they are issued—bond issues must be floated as "water system" bonds, "street paving" bonds, "school" bonds, and so forth. In such case, a city could not legally issue bonds to cover an excess of capital expenditures for various purposes over a "capital construction" tax levy. In many states, the constitutional and statutory limitations on local tax levies might prevent a city from shifting

¹⁴ See pp. 48 ff of this volume

from a program of borrowing for public improvements to even a partial "pay-as-you-go" program. If the current expenditures absorb all or the greater part of the tax rate the city is permitted to levy, it cannot impose an additional "capital construction" tax which would bring its total tax levy over the prescribed maximum. Necessary improvements can be financed only by borrowing. In several states, constitutional or statutory limitations on local taxing and borrowing powers must be modified to enable local governments to adopt more rational borrowing programs

Finally, there must be noted the supreme political obstacle to "pay-as-you-go" financing of state and local improvements. If a state or city administration announces an increase in tax rates, it is likely to bring upon its head the wrath of the taxpayers whose votes will decide whether it continues in office after the next election. Announcement of a bond issue to finance a governmental improvement has no such unwelcome political consequence, since a bond issue does not immediately take money from the pockets of the taxpayers. Even though in the long run the tax policy is better for the community than the borrowing policy, holders of political office cannot be expected to injure their careers by forcing a tax levy on a public which prefers to mortgage its future rather than pay cash in the present. Enlightened public opinion is prerequisite to any form of "pay-as-you-go" program for financing governmental improvements. It is worthy of note that where the merits of the cash-financing of continuing governmental improvements have been clearly and concisely put before a body of voters, "pay-as-you-go" programs have been ratified.

Borrowing to smooth budgetary irregularities

Governmental expenditures are generally spread fairly evenly through the fiscal year. Some current revenues—enterprise charges and monthly sales tax receipts, for example—flow in with considerable regularity. But most taxes are paid on annual or quarterly due dates. A few governments harmonize these divergent rhythms of expenditures and receipts by operating on a cash balance steadily lowered by expenditure payments, and replenished at intervals by

lumped receipts. Most governments, however, accomplish this adjustment by short-term borrowing—by bank loans in the case of local and state governments, by open-market sale of certificates of indebtedness or short-term notes in the case of the federal government.

Budgetary estimates of expenditures and revenues usually overshoot or undershoot the mark. Sometimes the governmental unit possesses a surplus at the end of a fiscal year, sometimes a deficit. A temporary deficit of this type adds somewhat to the short-term debt carried by the government during the early part of the next fiscal year to harmonize its expenditures and revenues.

Until recently, critical opinion held unanimously that, emergency and irregular capital expenditures aside, every government should endeavor always to balance its budget. A succession of annual deficits, covered by cumulated borrowing, was condemned as fiscal mismanagement. But from recent depression experience has developed a new proposal—the “cyclical budget.” Proponents of this idea insist that government budget balancing during severe depressions lasting a number of years is bad economics. During such periods, governments should maintain or even increase their expenditures as a means of counteracting recession or hastening recovery. And, also as a recovery stimulant, taxes should be held low. Resulting deficits should be covered by borrowing, by intermediate-term notes if such instruments are available to them. When recovery is accomplished, they can raise the tax level above that of expenditures, and pay off the debts incurred during depression. The high tax level during years of prosperity will discourage the development of a runaway boom.

With or without intent, the federal government and most state and local governments spent more from 1932 through 1937 than they received in taxes. Thus the “cyclical budget” argument falls into the category of justification after the event—a consideration, however, which does not in the least impair its economic validity. The major point of criticism is that, while it is easy for governments to carry out the first half of the arrangement—to incur deficits during depression—it is none too certain that they will always complete

the budget cycle by paying off the debt within a reasonable time following the depression. Present developments indicate that the "depression debt" accumulated by many governments from 1932 through 1937 will remain with them for a long, long time.

Borrowing for refinancing

Most federal government bonds are issued on a "callable-term" basis—the Treasury may, at its option, "call" them for redemption after a certain date, must redeem them at a later maturity date.¹⁵ If, when the optional "call" period arrives, current interest rates are lower than the face rates of the original bonds, the Treasury has an opportunity to borrow at the current lower rate and use the funds so obtained to retire the higher-rate old issue. A "conversion" of part of the Civil War debt to save interest was accomplished during the 1870's. Part of the debt of World War I was converted, with consequent interest saving, during the 1920's, and another part during the 1930's.

"Refinancing" borrowing is also useful in readjusting the maturities of outstanding debt to simplify the problem of retirement. A long- or intermediate-term bond issue may be floated to clear a heavy accumulation of short-term indebtedness which the government is unable to retire immediately. Between 1866 and 1869 the federal Treasury sold nearly \$1,000,000,000 of "5-20" bonds as a means of "funding" an equivalent value of floating debt. Each of the four Liberty Loans and the Victory Loan was in part a funding measure, since the proceeds were also used to retire the short-term certificates of indebtedness issued between loan dates. Sometimes a large "callable" long-term issue is "converted" into short-term debt so that it can be retired in convenient instalments over several years. The federal Treasury employed this expedient several times while reducing federal bonded debt during the 1920's. Again, between 1936 and 1941, after it had become evident that federal deficits would probably continue for a long time to come, the Treasury replaced \$6,400,000,000 of intermediate notes and short-term bills by long-term bonds whose maturities would not soon inconvenience it.

¹⁵ See p. 668 of this volume.

Few state or local governments have debt issues of sufficient magnitude or with sufficient market standing to permit them to engage in sound "refinancing" borrowing. When a state or local government "funds" short-term debt with a long-term bond issue, the transaction is usually a sign of bad fiscal management—the unit has failed to balance its budget for a series of years, and is taking a spend-thrift's way out of its difficulties. "Refunding" a maturing state or local bond issue by a new bond issue usually means that the government has failed to accumulate funds sufficient to retire the loan, and is irresponsibly continuing the debt. In some states, for example, various debt issues may be traced back through successive refundings to pre-Civil War days.

Supplementary nonfiscal reasons for borrowing

Never has an American government borrowed funds it did not need merely to serve some ulterior nonfiscal end. But a nonfiscal consideration is frequently offered as supplementary justification for borrowing which has a primary fiscal purpose. When Alexander Hamilton recommended the assumption of the Revolutionary Debt by the newly created federal government, he suggested that the federal bonds might serve as a large-denomination currency. Civil War "greenbacks"—a form of forced loan—were defended on the ground that they filled the currency vacuum created by the disappearance of gold from circulation. During the 1840's and 1850's, state bonds fulfilled a secondary function as the basis for bank note issues under various "free" banking systems; certain federal bond issues served an identical purpose under the national banking system until their retirement in 1935 and 1936.

Heavy taxation sometimes has a deflationary effect on the national economy. Governmental borrowing, as we shall see,¹⁶ is definitely inflationary. Sometimes a government may wish to provoke some inflation. During a war, for example, a touch of inflation is likely to spur general business activity. As part of its "recovery program," the Roosevelt administration wanted to "reflate." Under

¹⁶ See p. 657 of this volume

such circumstances, borrowing obviously serves a government's purposes better than does taxation.

Finally, over-liberal government borrowing is sometimes excused on the ground that it provides a form of supersafe investment for classes of investors who must seek security and ready marketability above all other considerations. Trust funds, for example, are invested largely in governmental issues. Our banking system would have to be radically changed if bank funds could not be placed in federal and state bonds. The federal system of old-age benefits and payroll taxes as established by the 1939 amendment to the Social Security Act is based on the expectation that a reserve fund of \$12,000,000,000 will be accumulated by 1955, all of which must be invested in federal debt issues. In the future, as in the past, pleas for "pay-as-you-go" financing by federal, state, and local governments will probably be countered by the argument that these governments are under obligation to provide an ample supply of such issues for investors who must have government securities.

CHAPTER XXVI

Principles of Governmental Borrowing *(Concluded)*

THE GOVERNMENT BOND MARKET

DURING World War I, the federal Treasury directed stupendous "drives" to sell War Savings Stamps, Liberty Bonds, and Victory Notes to private persons, poor as well as rich. Commercial banks, savings banks, and other institutional investors bought a substantial proportion of the bonds and notes, but for the first time in American fiscal history individuals were also primary buyers of government securities. Again in the spring of 1941, the federal Treasury undertook to sell "Defense" notes in billion-dollar volume directly to individuals.

Furthermore, in normal times rich individuals are likely to buy state and local bonds with capital not actively employed in productive operation or financial control, since the interest on such investment is exempt from the federal income tax¹. Also, they frequently accumulate large values of federal bonds to provide their executors or administrators with a ready means of paying the federal estate tax. There are also some individuals of more moderate means who buy government bonds because they consider them safer than any other form of investment. But these individual purchases constitute normally only a fraction of the market for government bonds. As shown in Table 33 (p. 686), individuals held only one-third of the total of government bonds outstanding in June 1940. The most important category of government bond buyer was the commercial banks, which held \$20,700,000,000 of the \$54,800,000,000 then in private ownership. Another \$8,200,000,000 was held by insurance companies, and an additional \$5,000,000,000 by tax exempt institutions.

¹ See pp. 682 ff. of this volume

In analyzing marketing appeals and marketing procedures for government bonds, we must distinguish between the normal sale of these bonds to their regular buyers upon a strictly investment basis, and the extraordinary techniques employed in wartime when special effort is made to reach beyond the ordinary investment market and sell to the millions of individuals who normally do not buy government bonds.

Normal buying motivations

In ordinary peace times, a government bond issue must be sold as an investment proposition. A commercial bank is not influenced in its purchase of federal bonds by the consideration that the proceeds will provide work relief or farm aid. Nor does an insurance company or a fraternal organization invest part of its reserves in the bonds of some city or county because the former intends to build a school or the latter a stretch of motor highway. Normally, a government bond is bought upon the same considerations that influence investment purchase of other securities. These considerations, to be discussed more fully in the next chapter, are (1) the yield of the bond, (2) special incidents that may affect its yield, (3) redemption provisions and other security elements, (4) the maturity of the loan, and (5) the credit standing of the issuing government as determined by its record of past default and the probability or possibility of default upon the issue in question.

Normal marketing channels

The federal government normally sells its debt issues directly to banks and institutional investors. A few states and large cities have also had some success in this direction. Most state and local governments, however, must utilize the services of investment houses to market their bonds.

Federal borrowing technique starts with an estimate by the Treasury of the yield or interest rate which must be attached to an issue to accomplish its floatation in view of current market rates and conditions. Tradition and prestige demand that every federal offering be oversubscribed. This involves a slight generosity in yield rate—

but not too much, since the Treasury would thereby obligate itself to extra interest payment for a uselessly large oversubscription.

When the offering yield rate has been determined to a minute fraction of a per cent—by face interest rate in relation to offering premium or discount in the case of bonds and notes, by discount alone in the case of bills—the Treasury, through the federal reserve banks which act as fiscal agents in the transactions, sends a description of the issue and subscription blanks² to a long list of potential institutional and individual purchasers. With the usual oversubscription before it, the Treasury allots the issue, each subscriber receiving an allotment pro rata to his original subscription. Small subscribers are sometimes allotted the full amounts of their subscriptions.

A state or local government marketing a debt issue through an investment house does not follow quite the same procedure. An interest rate is established at the nearest half or quarter per cent approximation of the market yield rate for the issue. In many cases the government must choose the nearest fractional interest rate *above* the probable yield rate, since state constitutions and statutory limitations frequently forbid the sale of a debt issue below par. Next it advertises to the investment houses which handle issues of the type it wishes to float, and asks for competitive sealed bids on all or part of the issue. Bids are made in the form of offers of premiums over the par value of the bonds, and the issue is sold to the investment house or syndicate of underwriters making the best bid. Resale by the underwriters to ultimate customers at a higher premium to give them a profit is the problem of the underwriters, not of the borrowing government. Resale spread on government bonds is generally quite narrow, but municipal bond distribution has come to be a highly skilled low-cost technique, and a coordinated series of jobbers, wholesalers, and retail distributors all squeeze a profit from this margin. Small issues of minor governmental units are sometimes handled by local commercial banks which are able to negotiate a local sale.

² Sample federal bond subscription blanks are presented in Appendix I, pp. 851-853 of this volume.

"Patriotic" loans

In times of war and other national emergencies, the federal Treasury may reach beyond the normal bank and institutional market for its securities, and endeavor to sell an issue or a series of issues directly to individuals, poor and rich. Two reasons motivate this action. (1) A proposed bond issue may in all its details be quite acceptable to the regular investment market, but its size may be too great for easy absorption. Appeal to patriotic sentiment can direct the sale of the issue into channels which could not have been reached through the ordinary investment approach, and thus permit the floating of the larger issue. Personal purchase of government bonds, ordinarily a minor item, can be whipped up into an important supplementary market, or even a temporary major market. (2) By inducing the civilian population to buy bonds during a war period, the government thereby deprives them of purchasing power which they would otherwise employ to buy consumption goods of all kinds. Production of these consumption goods would utilize materials and employ labor needed for the armament effort associated with the war or defense situation. Thus a borrowing program directed to the people of the country performs the double service of providing the federal government with needed funds, and reducing civilian demand that would compete with the government's war demand.

A special technique is needed to sell billions of dollars of war or defense bonds to millions of people who are not accustomed to bond buying and who would rather use their available funds for personal consumption expenditure. Thousands of convenient purchasing centers must be provided—post offices, banks, savings banks, special booths at central locations. Denominations must be made convenient for the small buyer. In addition to the customary \$1000 and \$500 denominations suitable to institutional and rich investors, the bonds must be sold in units of \$100, \$50, and \$25. Even greater fractioning can be accomplished by the instrumentality of war or defense "savings stamps" in twenty-five cent denominations, which can be pasted into "books" until sufficient value has been accumulated for conversion into a small-denomination bond. Great "drives"

must be instituted, with posters, radio addresses, public speakers, and newspaper publicity, to whip up patriotic sentiment and overcome popular inertia. Under the drive of propaganda, laggards, by being branded "slackers," are shamed or coerced into buying. Properly planned and expertly handled, an effective "drive" can obtain billions of dollars from a war-excited people.

"Patriotic" loans like the five floated by the American government during World War I and the new series begun in 1941 are an essential element of war finance for the two reasons stated earlier. Some writers on Public Finance, however, are sharply critical of them, charging that their failure to conform with normal investment standards causes a subsequent decline in the prices of the bonds, weakening government credit and mulcting purchasers of the issue. This criticism fails to give due consideration to the circumstances under which patriotic loans are floated. Since a greater volume of bonds is being marketed than the normal investment market could possibly absorb, it is impossible for the loan to conform to "normal" investment standards. The interest rate attached to the bonds, the maturities, the provisions for redemption—all should be adjusted primarily to the popular market rather than the normal investment market. But because the incidents of the loan do not conform to the special demands of regular investment, that market is likely subsequently, when trading in the bonds begins, to place a discount upon the issue. Furthermore, market interest rates tend to rise during a war period, so that earlier loan issues, which were based on the lower interest rate, suffer a capitalization loss.

Two precautions can be taken to reduce the distortion that results when loans floated on a patriotic basis become subject to normal investment market evaluation. (1) Obstacles can be placed in the way of any large-scale shift of the bonds from the original private holders to the general investment market. An extreme method would be to make them nontransferable. Such provision, however, might interfere seriously with their marketability even to the general public. The Treasury apparently accomplished much the same result in 1941 by issuing its bonds on a discount basis—a form that gives a bonus to retention by the original purchaser, and prevents

subsequent quotations that would show that the issue had fallen below par. (2) If the war issues are given short maturities, they can be refunded subsequently into issues directed at the regular investment market and conforming to that market's requirements. Any discount that develops on the war issues while they are outstanding will be slight, since discounts resulting from divergence between yield and market rate are determined by the number of years' divergence that has to be capitalized into the discount. As against this advantage of short maturities on war loans is the consideration that their maturing shortly after the war ends may cause the government financial embarrassment if the general investment market is not suitable to refunding operations.

Forced loans

Compulsory or forced loans were employed by several European governments during and after World War I, and again in connection with World War II. Heretofore they have never had any place in American finance. Until very recently they were viewed as the last desperate resort of governments whose credit had collapsed and which had exhausted the appeal of patriotism.³ Since 1939, however, there has been a revolution of opinion on this point, and a number of economists now hold that forced loans are an essential element of the war finance of governments in an absolutely sound credit position.⁴

The argument for forced war loans is based on the proposition, stated earlier in this volume,⁵ that during all-out war or preparation for war, many of the country's productive facilities must be diverted from civilian production to war production. Civilian purchasing power available for the buying of ordinary consumption items must be cut down to produce a correspondence between production and consumption demand. Taxes should be the major wartime in-

³ This was the viewpoint taken in earlier editions of this study

⁴ See John M. Keynes, *How to Pay for the War* (Harcourt, Brace and Co., New York, 1940), Chs. V, VI, and VIII, and William J. Shultz, *Fiscal Possibilities for National Defense* (Conference Board Studies in the Economics of National Defense, No. 6, New York, 1940), pp. 6-8

⁵ See p. 44 of this volume.

strument for absorbing civilian purchasing power. But taxes alone cannot accomplish the full reduction necessary. Voluntary "patriotic" loans can effectively absorb civilian purchasing power so long as the pressure is not too intense. But economic mobilization for modern warfare requires an absorption of civilian purchasing power beyond the power of voluntary loans. When buying a government bond means that a family will have to sacrifice Sunday auto-driving, or forego a new radio when the old one is wearing out, or go without new clothes when the old are threadbare, there are many who simply will not buy the bond in spite of all patriotic pressure. Yet it is just these very consumption sacrifices that must be compelled if war effort is to be successful. The forced loan compels all to make these sacrifices, where the voluntary loan makes a plea that many fail to heed. And, from another point of view, the forced loan is fairer than the voluntary one, since it distributes the sacrifice over the entire population, whereas the voluntary loan permits "slackers" to escape their share of the nation's burden.

A forced loan would require a special technique for its administration. For England John M. Keynes suggested that every individual should deposit a compulsory quota of savings, graduated according to income, in savings accounts which would be made available to the government.⁶ This method might not be effective in the United States, but there are other and perhaps better possibilities. The machinery for collection of the payroll taxes⁷ could be used for a federal forced loan. Employers would deduct a uniform or graduated fraction of all wages and salaries to be paid over to the government, the wage- or salary-earners would receive certificates or bonds for the amount so held back. Other recipients of income could be reached through their federal income tax returns; in addition to the tax on their income, they would be required to subscribe a graduated proportion of their incomes for bond purchases.

A forced loan program of this type would have two advantages over any attempt to accomplish full reduction of consumption

⁶ Keynes, *op cit*, pp 43-44

⁷ See p 465 of this volume

income by taxation. (1) Special circumstances of the holder of forced-loan securities could be taken into account in a way impossible under taxation. An individual who needed funds for debt service, medical payments, or other purposes not involving consumption expenditure, could be permitted, upon proper showing of the necessity, to sell his bonds back to the government and thus obtain the needed funds. Similarly a corporation that needed funds to enlarge its capacity for essential war or defense operations could resell the bonds it had previously been compelled to buy. (2) If a stimulation of consumer purchasing is desirable in the economic dislocation following the cessation of war, the government can promote such stimulation by refunding the forced-loan bonds and thus providing millions of individuals with lump sums for consumption expenditure. The funds for such refunding would be provided by the sale of a new issue to commercial banks and the federal reserve banks, which would create the credit for such purchase.

ECONOMICS OF GOVERNMENTAL BORROWING

Governmental borrowing and debt redemption differ in their economic effects according to whether the loans are marketed within the territory of the borrowing government or are sold outside its jurisdiction. The economic effects further differ according to whether the proceeds of governmental loans are expended at home or abroad. To facilitate analysis of the complicated elements of the problems involved, consideration will be given first to "domestic" loans—those marketed at home, and second to "foreign" loans—those marketed abroad.

Floating domestic loans

The proceeds of a domestic loan may be spent either within the territory of the borrowing government, or outside its jurisdiction. In this country the former is the more common situation, and will be considered first.

When a government raises funds by a loan, it thereby acquires

a given purchasing power. If the funds lent by the bondbuyers would otherwise have been utilized to purchase consumption commodities or would have been invested in the creation of new capital goods, the increase of government expenditure by the amount of the loan will not affect the total of purchasing power coming upon the market, since private expenditure will be correspondingly reduced. The government will buy certain items which the individual or institutional investors would not have purchased, and vice versa, so that distribution of purchasing demand and production activity, and hence price relationships, may be altered, but the general price level will remain the same. If investment funds which would otherwise have gone into the creation of new capital properties are diverted to government use, private business expansion may be checked. If only "excess savings"—the excess of savings over and above what is needed for business expansion—are absorbed by the government, then the effect of the borrowing is to check capital inflation.

In their effects, most state and local borrowings may conform closely to the analysis above. But federal loans and some state and local borrowings do not produce a complete diversion of purchasing power from bondbuyers to governments. As already indicated, commercial banks are important purchasers of federal bonds and of some state and local issues. When commercial banks and federal reserve banks buy government bonds, they make their purchases with credit funds which they themselves create. Payment is made by establishing a deposit to the credit of the borrowing government. Thus the government obtains purchasing power, while the people surrender none, and a double demand for goods and services comes upon the market. As the government expends the proceeds of the loan, the government deposit is transferred to private accounts. The total of bank deposits, as a monetary medium, is increased. Furthermore, some portion of the government bonds bought by individuals and business corporations is generally used as collateral for bank loans which otherwise could not be negotiated, so that these bondbuyers regain part of their previous purchasing power through an expansion of bank credit.

tionary trend, or cause a recession of business activity, according to current business conditions.

Besides these direct financial effects of expending abroad the receipts from a domestic loan, there are interesting reactions upon international finance, which can be indicated only superficially here. The government's purchases abroad create an extra volume of exchange bills upon its own financial centers. The effect is the same as though an equivalent value of imports had been superimposed upon the normal balance of trade and payments of the country making the foreign payments. Other things being equal, the international exchanges will turn against its currency. If no international stabilization of exchanges is operating, there will be an export of gold (if gold is enjoying free international movement), or a stimulation of its exports. In the case of the American government's expenditures in France during World War I, these international financial effects of the loans were obscured by the artificial status of international exchanges at the time.

Floating foreign loans

If a government floats a loan abroad and expends the proceeds within its own borders, the resulting inflation is greater than when a domestic loan is expended at home, because no purchasing power whatsoever is absorbed within the borrowing country to offset the purchasing power acquired by the government. The government uses this additional purchasing power to bid against its own citizens for services and materials. And since these citizens have surrendered none of their original purchasing power by reason of the loan, they continue their attempts to purchase materials and services according to their original desires. Competitive bidding between the government and its citizens must either expand domestic production, or force up prices sufficiently to expel enough private demand from the market so that the government can satisfy its needs; current business conditions—whether the industrial structure is operating at full or partial capacity—will determine if the effect is to increase prices or promote business.

In this case also an interesting secondary effect in the field of international finance appears. The proceeds of the foreign loan can become available to the borrowing government only by the sale of drafts upon the foreign deposits now made available to it. The effect is exactly the opposite of the case previously considered; international exchanges turn favorable to the currency of the borrowing country, so that there is a tendency for gold to move in and for imports to increase.

Funds borrowed by a government from abroad and expended abroad do not affect domestic business activity, and cause neither inflation nor deflation. Domestic markets are not affected either by the floating of the loan, or by the expenditure of the funds derived from the loan, nor is there any influence on the international exchanges.

Redeeming governmental loans

Usually, the economic effects of redeeming or retiring a governmental loan are the inverse of those produced by its floatation. If governmental funds expended in this country were originally obtained by a loan abroad, repayment involves withdrawal of purchasing power from domestic consumers or investors and its transference out of the country. An element of purchasing power is by taxation definitely absorbed from the domestic market, and it is not replaced by any substitute demand. This is likely to induce deflation, which offsets the business stimulation or inflation originally caused by the borrowing and expenditure of the funds.

Just as the business stimulation or inflation produced by a domestic loan is less marked than that induced by a foreign loan, so the retirement of a domestic loan produces a less marked deflation. Some commodity price and credit deflation, however, is almost certain to accompany the redemption of a domestic loan. True, the purchasing power which the government draws from its taxpayers is paid out to the bondholders whose bonds are redeemed. But if these bondholders were commercial or federal reserve banks, the redemption merely converts a bank investment into an additional element of bank reserve, without creating new purchasing

power to replace that surrendered by the taxpayers. If the bondholders were individuals or institutional investors, they may use the repayment fund for current expenditure or new investment, which will offset the deflationary effect of the taxes. But to the extent that any of these bonds had previously been used as collateral for loans, their redemption adds little to the actual purchasing power of the former bondholders.

Converting governmental loans

Because of the different economic effects of floating loans to individuals or to banks, and of retiring loans held by individuals or by banks, the federal Treasury can exercise considerable influence on the trend of business activity by its debt conversion operations. If, after a war, it calls in a loan originally sold primarily to individuals and still largely held by them, the effect of such retirement will be to bestow a tremendous volume of new purchasing power upon the country. If the Treasury can obtain the funds for this retirement without absorbing purchasing power from any other source, the country will enjoy a powerful business or price stimulation. Marketing of a new issue to the commercial banks offers the Treasury the perfect opportunity to acquire funds without absorbing purchasing power. Of course, in some future time when the new issue bought by the banks is retired, there will be a loss of purchasing power. However, through its control over the time element in conversions and retirements, the Treasury can accommodate its debt management program to the economic situation of the country, and make it a positive rather than a negative factor in economic control.

YIELD ON GOVERNMENTAL BONDS

The "price" which bondbuyers receive for lending their funds to a government, the "price" which the borrowing government must pay for a loan, is generally expressed in terms of the "yield" of the bonds. "Yield" takes three factors into consideration: (1) the "face" rate of interest, (2) calculated against its selling price, which may involve either a discount or a premium on par value,

(3) with an allowance for annual amortization of the discount or premium. A nine-year $3\frac{1}{2}$ per cent bond sold at 94.58, for example, would have a yield of 4.23 per cent

Yields on government debt issues marketed within the past twenty-five years have ranged from a minute fraction of one per cent to over eight per cent. Chief among the many factors which contribute to this wide range of "yield" prices for government securities are the credit standing of the borrowing government, the maturity and redemption terms of the issue, tax exemption and other special incidents, the trading market which will exist after issuance, and the current market rates of interest.

"Credit standing" of a government is the investment market's estimate of the probability of its making full interest payment on debt offerings and ultimately redeeming them in cash exactly according to the face terms of the debt instruments. The higher a government's credit standing, the lower is the yield its bonds need carry. An outstanding consideration is the economic resources of the territory embraced by the borrowing government relative to its outstanding debt. With all the resources of the nation to draw upon, the federal government enjoys an unparalleled advantage in this respect; so its issues bear the lowest yield. State governments generally are better off than any of their local units. Obviously a wealthy community has greater leeway in imposing debt-service taxes on its residents than one whose inhabitants are on a bare subsistence level; default on bond interest or redemption by the latter government is much more likely than by the former. And other things being equal, a community with a small debt is better able to service it than one with a large debt. Investment manuals covering government issues inform their readers in minute detail as to population, assessed valuations, tax rates, tax and debt limitations, and outstanding issues of all state governments and most local units. The investment market studies this information and insists on yield variations to cover these differences in bond safety.

Another consideration which affects governmental credit standing is the prior debt record of the community. If it has once defaulted on an issue, with or without justification, it is thereafter

branded with the stigma of irresponsibility. Rightly or wrongly, its issues are stricken from the "approved" lists for savings banks, trusts, and other regulated investments. To overcome the prejudice against them, subsequent debt issues, if they can be placed at all, must bear high yield rates. State and local governments in the South are still compelled to issue high-yield bonds because they repudiated their "Reconstruction" debts during the 1870's.

The maturity term of a debt issue also affects its yield in a number of ways. The longer the term of a bond issue, it might be thought, the greater the probability that intervening events might interfere with eventual redemption; hence the risk would be greater and the yield higher. But this consideration may be offset by others. Most institutional investors prefer to keep their reserve funds invested as long as possible in a known safe issue, and distinctly dislike the trouble and risks involved in frequent turnovers of their portfolios; they may be willing to take a slightly smaller yield for a longer term of a safe issue. Furthermore, if the bond issue floated has a high yield rate because current interest rates are abnormally high, the longer its term—and hence the longer the continuation of its high yield through later years when current interest rates will, probably have fallen—the more willing are investors to take a yield rate under the current market level. And contrariwise, if the issue is floated with a low yield in a period of abnormally low current interest rates, investors will demand somewhat more than the current yield rate to assure them a reasonable average return over the entire life of the issue.

Tax exemption and any other special benefit feature of a government debt issue of course lowers the yield basis of the issue in accordance with the measurable value of the incident. Yield on federal issues is unquestionably influenced by the circumstance that bank examiners favor them in bank portfolios, and that they are par collateral for member-bank borrowing from federal reserve banks.

Presence of a continuous trading market in a government's securities after they are issued gives them an element of "liquidity" highly valued by many classes of investors. This is reflected in the

lower yield accepted. Although the holder is not *compelled* to release his bonds until their maturity dates, he knows that he can sell them at any time without special, substantial loss. Listing on one of the stock exchanges is the most valued trading privilege for a public bond, since it ensures absolute and immediate liquidity at all times. Only federal issues enjoy this privilege. Constant over-the-counter dealings in many state and local bonds outstanding in large blocks give them relative liquidity. But no organized trading market exists for the small issues of many thousands of minor communities and they often become relatively "frozen" investments immediately after initial placement; buyers can usually be found for such issues at any time through brokers who specialize in "municipals," but only by substantial sacrifice in sales price.

Finally, underlying all individual variations in "yield prices" of government securities is the common factor of current interest rates. Like any other borrowers, governments must pay more for their borrowings when investment funds are "dear" than when they are "cheap." Three-year Treasury notes issued in the summer of 1921 bore $5\frac{3}{4}$ per cent interest, for example, as against $4\frac{1}{4}$ per cent on identical notes issued in 1922. When the market rate fell in the 1930's, short-term federal issues could be sold with a yield of a fraction of one per cent. The yield rate on Treasury bill offerings frequently changes fractionally from issue to issue as short-term money rates vary. In the case of state bonds, there was a persistent reduction of yield rates during the 1920's and 1930's; whereas in 1921 the range was from four per cent to over six per cent, in 1938 it was from one to four per cent, with nearly half of the issues sold at two per cent or under.

State and local governments have no choice but to adjust the yields of their bond offerings to market conditions. The federal government, however, can to some extent control market interest rates to suit its borrowing needs. Treasury policy is an influential consideration to the governing body of the Federal Reserve System, which determines federal reserve rediscount rates. These at times are a controlling factor on current money rates, which in turn are an indirect influence on investment fund rates. In 1919, for ex-

ample, when all banking considerations dictated prompt and sharp increase of rediscount rates, the Federal Reserve Board held them low in order that the Treasury might market its \$4,300,000,000 Victory Loan at $3\frac{3}{4}$ and $4\frac{3}{4}$ per cent instead of a probable 5 or 6 per cent. More than once subsequently, Federal Reserve acts or announcements have obviously been timed to help, or at least not hinder, some Treasury debt action.

CHAPTER XXVII

Governmental Debt Management

THE possible variations in the detailed provisions of a governmental debt issue are almost infinite. The terms of governmental loans may range from a few days to perpetuity. Various assurances that the bonds will be redeemed at maturity may be provided—a sinking fund may be set up, the issue may be serially retired during its term, higher units of government may guaranty or underwrite the issues of subordinate units. An issue may be “sweetened” by tax exemption and other bonus provisions to make it more marketable or to hold down its yield.

All of these variations affect the investment character of government debt issues and influence their yields. Also they produce various costs or savings, various conveniences or inconveniences, for the issuing government. If the officials who are responsible for the borrowing policy of a government unit exercise an intelligent choice among the many possibilities open to them, the outstanding debt of their government will be maintained in convenient manageable form, its credit standing will be high, and the yield cost of its borrowing will be held down. The penalty for poor public debt management may occasionally be fiscal stringency to the point of bankruptcy, and is certain always to be a higher cost of borrowing.

MATURITIES OF GOVERNMENTAL LOANS

Governmental loans are marketed with maturities of three months, six months, nine months, one year, two years, five years, and higher year multiples. In their legal incidents, there are no distinctions between governmental loans with long maturities and those with short maturities. The maturity of a governmental loan, however, has a marked relation to its fiscal use. For the purposes

of this section, governmental loans are divided according to their maturities as of date of issue into "long-term" loans, with maturities over five years; "intermediate" loans, with maturities over one year but not more than five years; and "short-term" loans, with maturities of a year or less.

Perpetual loans

European governments have frequently issued bonds without definite maturities but with provision permitting the government to call them in after a stated period. Such issues need not be redeemed unless and until the government finds it convenient to do so. A government carrying a "perpetual" debt need never make an appropriation for debt retirement or for sinking fund charges; yet it can never technically be in default as to the principal of its debt. But since the borrowing government is under no pressure to redeem such loans, it is not likely to make special provision for their redemption; with the result that the debt does in fact tend to become permanent, thereby weakening the future credit of the government.

American governments have rarely avowedly incurred permanent debts.¹ Much of the local debt, however, has the character of permanent debt because of the practice of issuing bonds with maturities adjusted to the life of the improvements they are intended to finance. If thirty-year bonds are issued to cover the construction of a highway expected to last thirty years, a new bond issue to finance replacement of the highway must be floated as soon as the old issue is paid off. Thus, as long as any particular improvement is maintained, an item of local debt must be continued. Successive refundings of state and local obligations for which no adequate retirement provision has been made have also had the effect of burdening the governments involved with a quasi-permanent debt.

When the National Banking Acts of 1863 and 1864 required the deposit of federal bonds for the issue of national bank notes, con-

¹ The single American example of the European type of nonmaturing governmental loan was the federal \$600,000,000 Consolidated Debt ("Consols") of 1930, floated in 1900, and redeemable after 30 years, but without any specified maturity date. This issue was retired in 1935 as an incident of eliminating national bank notes from the currency system.

tinued maintenance of a substantial federal debt was made an element of the country's currency system—at least, while national bank notes remained a part of the currency system. With the elimination of the national bank note circulation in 1935 and 1936, this awkward “freezing” of the “currency-privilege” federal debt was ended. But the Social Security Act of 1935 opened a new and wider possibility of perpetuating federal debt. This act provides that Congress shall make an old-age benefit appropriation each year. Any excess of this appropriation over current withdrawals is to be set up as a reserve fund, to be invested in federal debt obligations. Under the 1939 amendment to the Social Security Act, if Congressional appropriations to old-age benefits each year continue to approximate the amount received in payroll tax receipts, the reserve fund will equal \$12,000,000,000 by 1955. Unless the provisions for old-age benefit financing are subsequently changed, the federal government stands committed to accumulate and maintain \$12,000,000,000 of debt outstanding in perpetuity.

Long-term loans—“callable-term” provision

Except for the so-called “Consols of 1930,” the federal Treasury has always set a definite maturity date for its bond issues. The shortest bond term ever set, as distinguished from intermediate-term note issue, was eight years for the $3\frac{1}{4}$ per cent Treasury bond issue of 1933; the longest was fifty years for the 1911 Panama Canal loan. But in addition to a maturity date, nearly all federal bond issues since 1862 have carried an earlier “call” date. Thus, in 1862 the Treasury was authorized to issue \$500,000,000 of 6 per cent bonds which would mature in twenty years, but would be “callable” in five. A later Civil War issue was made “callable” in ten years, redeemable in forty. The first Liberty Loan bonds had to be redeemed in 1947, but could be “called” any time after 1932. All Treasury bonds issued during the 1920's and 1930's have a spread of two to ten years between the “call” and maturity dates. Twenty states have upon occasion issued “callable-term” bonds during the past two decades. A few of the larger cities also borrow by means of these “callable-term” bonds.

As previously indicated,² callable-term bonds facilitate conversion operations to save interest or smooth out retirement operations. Even where no conversion intervenes, callable-term issues make debt retirement easier than fixed-term issues, since the government has an optional period of several years during which to redeem or not according to its fiscal circumstances. The investment market does not care for callable-term bonds since they introduce an element of uncertainty into yield-basis calculations of premiums and discounts. Market dislike translates itself into insistence upon slightly higher yields for callable-term than for fixed-term bonds—yield on callable local bonds was one-twelfth higher than on fixed term bonds during the 1930's.³ An exaggerated view of the importance of this consideration has apparently discouraged state governments from issuing callable-term bonds as often as they might, with the result that they have lost heavily by being unable to take advantage of favorable developments in the bond market. Local governments are generally prevented from issuing such bonds by constitutional and statutory limitations.

Long-term loans—maturity period

Most state and local bonds are issued to finance capital projects, either enterprises or non-revenue-yielding buildings and properties. At the present time the principle is widely accepted in many quarters that the life of the improvement is the proper maturity for the debt financing that improvement. Since future generations as well as the present generation will benefit from the improvement, it is argued that the payment for it should be spread among all who benefit. Accordingly, during the 1920's and 1930's, state bonds were issued with maturities up to and over fifty years, with a median period of fifteen to twenty years

This is a mistaken view.⁴ As indicated above, the adjustment of governmental loan maturities to the life of the improvements

² See p 646 of this volume

³ Committee on Municipal Debt Administration, *The Call Feature in Municipal Bonds* (Municipal Finance Officers Association, Chicago, 1938), p 12

⁴ See Paul Studensky, *Public Borrowing* (National Municipal League, New York, 1930), Ch VI

tends to result in a perpetual debt. Under this system, governmental debt piles up rapidly until it reaches the constitutional or statutory limit; then, no matter how vital the need for further improvements, they cannot be constructed. Since every dollar of public improvement is offset by a dollar of governmental debt, constitutional or statutory limitations on state or local borrowing become limitations on the value of the public improvements which can exist at any time. Nor does this principle take account of circumstances in the credit market. When interest rates are low, a government may be justified in borrowing for a long term, but when interest rates are high the maturity of its borrowings should be short if it is not to be saddled with heavy interest charges over a long period of years. While the life of an improvement financed by a state or local loan may be properly viewed as setting a maximum maturity for the loan, a shorter maturity is often preferable.

A program of borrowing to finance only the excess of a year's capital expenditures over a minimum covered by a tax levy, recommended in an earlier chapter,⁵ runs flatly counter to the theory that the maturity of a government loan should be measured by the life of the improvement it finances. Excess-capital-expenditure loans would apply to no particular improvement. The cost of paving streets, building schools, and constructing parks would be lumped together, although the schools might outlast the streets, and the parks would outlast both. Such indebtedness would cover part of the cost of capital construction undertaken during the course of the year, rather than the entire cost of paving some street, building some school, or constructing some park. There would be no particular improvement to whose life the maturity of such loans could be related. Instead, their maturities would be determined by such factors as the maturities of the borrowing government's outstanding loans and by the possibility of future changes in interest rates.⁶

⁵ See p. 642 of this volume

⁶ Carl H. Chatters and Albert M. Hillhouse, *Local Government Debt Administration* (Prentice-Hall, New York, 1939), pp. 23-24

Intermediate loans

Intermediate borrowings, with maturities from one to five years, are comparatively recent in American federal borrowing. Intermediate borrowing has very limited uses, but within these limits this form of borrowing is most useful. When an emergency or war loan is certain to be the last of a series, and it is probable that efforts will be made within a few years to refund the debt resulting from the emergency or the war, a loan of intermediate duration simplifies the subsequent refunding procedure. Thus the federal government very properly made the Victory Loan of 1919 redeemable in four years and callable in three. A large proportion of the federal borrowings during the 1930's likewise took the form of intermediate-term notes.

Intermediate debt also permits early payment of a portion of an outstanding governmental debt after it is refunded. In its refunding operations during the 1920's, the federal government set up a portion of its debt in the form of Treasury notes, some (series A, B, and C) maturing in five years and callable in three, others (the adjusted service, civil service retirement fund, and foreign service retirement fund notes) maturing in five years and callable in one year.

Intermediate loans are also used occasionally by some city governments. A city whose outstanding debt is in the form of callable-term bonds may discover a favorable opportunity to convert a portion of such debt by floating a new loan at a lower rate of interest. To insure continued retirement during the years immediately following the conversion, part of the new loan may be of intermediate duration. A city operating on a "pay-as-you-go" program may also resort to serial loans of intermediate maturities when exceptional emergency expenditures cannot be met from current revenues.

Short-term loans

Short-term governmental borrowing takes various forms: short-term certificates or notes sold to banks or other investors, bank

loans, warrants paid out in place of cash, and unpaid bills and claims. Short-term borrowing is properly employed, as already explained,⁷ to smooth out irregularities between expenditure and income flows, and to finance a government temporarily during a period when tax receipts unexpectedly fall off. Some cities have also found it more convenient to finance the construction of a series of improvements by short-term borrowings, subsequently funding them into consolidated long-term debt, than to float a separate long-term issue to finance each individual improvement.

In 1917 the federal Treasury was authorized to issue temporary certificates of indebtedness up to a total outstanding debt of \$10,000,000,000. Later the permissible total was increased to \$20,000,000,000. During the war years, the Treasury used temporary certificates to obtain funds as needed in anticipation of the Liberty and Victory Loans, retiring outstanding certificates from the proceeds of each loan. Certificates were again employed during the 1920's to obtain current funds between quarterly income tax payments. Since 1929, a new form of short-term debt instrument, the Treasury bill sold on a discount basis, has been utilized as the flexible element in the federal debt structure; over \$1,600,000,000 of such bills were outstanding on June 30, 1941.

Some state and city governments are also able to sell short-term bills, certificates, notes, or "revenue bonds" to the investment market. Recent statistics on this subject are not available, but at latest report, as of 1938, state governments had less than \$75,000,000 of such short-term debt outstanding. The 1938 short-term debt of cities with populations over 100,000 was over \$400,000,000.

A warrant is a departmental order to a governmental disbursing officer to pay the holder in accordance with the terms of the warrant. It is an established part of the financial administrative machinery, and if properly used is not subject to criticism. Many local governments, however, finding themselves pressed for cash, make their warrants payable in three or six months instead of on demand. In some cases the warrants are made payable out of some subsequent tax receipt. Holders of such warrants are in effect

⁷ See p. 644 of this volume.

compelled to extend credit to the government for the term of the warrant. They may discount the warrants at local banks, but not for their face value. All parties having business dealings with such governments, except their salaried employees, take this circumstance into account, and make a corresponding addition to their charges. The practice of allowing bills to go long unpaid leads to similar excess charges. Financing a government by means of warrants payable in the future or by unpaid bills is unprincipled, costly, and without excuse.

REDEMPTION PROVISIONS AND OTHER SECURITY ELEMENTS

Bonds of two governmental units, alike in all their incidents, may sell at widely variant yields. The explanation is the "credit standing" of the two governments—the respective probabilities that each will redeem its bond issue in full on the date of maturity. Part of a government's credit standing is its past record of default or absence of default. Part is the investment market's estimate of the relationship between the debt burden of the government and its capacity to carry that burden. But part of the market estimate of a government bond issue turns on the issue itself—provisions made by the government for accumulating funds to retire the issue at maturity, "earmarked" revenues, and other safeguards that reduce the likelihood of default before or at maturity.

Default

Default is an unthinkable and unmentionable contingency in public credit, but—it happens. The federal government has never been put to the shame of default. But seven states fell temporarily behind in interest payments on their debts in 1839 and 1840; during that depression period, Mississippi and the territory of Florida repudiated outright the principal of two bond issues. During the 1870's ten southern states repudiated \$115,000,000 of state debt incurred by their "carpetbag" governments in the preceding "Reconstruction" period. And three states fell behind on debt service

payments in 1933. Local governments beyond count have willfully or unwillingly defaulted during the past hundred years, particularly in depression periods. Because of prior overborrowing, and revenue deficiencies resultant from depression, over 3000 municipalities were in arrears as to interest payments or were unable to pay due principal in 1935. As of February 1, 1941, 1261 were still in default.

Outright repudiation of a debt issue is an irreparable blow to a government's credit, and usually every attempt is made to avoid it. Where cash is not available for interest payments, a government tries to persuade its bondholders to accept scrip, redeemable after some stated period. Where constitutional difficulties prevent scrip payment of interest, and default is inevitable, the debtor government endeavors to repair the injury as soon as possible by the payment of back interest. Defaults on principal have often been avoided by refunding issues. When avoidance of default proves impossible, repayment is generally made at the earliest date permitted by the debtor government's finances. The three states reported in default in 1933 had cleared themselves by October 1935.

As the 1929-1933 recession proceeded, it became evident that many of the communities slipping into default might never be able to redeem in full the tremendous debts with which they had loaded themselves during the earlier years of optimism. Two types of remedial legislation were passed. Four states provided for court receiverships of defaulting municipalities. Maine, New Jersey, and North Carolina provided for "administrative" receivership under a state agency, and Massachusetts passed special receivership statutes for particular defaulting communities. All these receivership laws provide for the appointment of a temporary "receiver" or "financial administrator" to manage the finances of the defaulting community until the debt default has been cleared. The second approach to the problem was the federal Municipal Bankruptcy Law of 1934 which provided that, upon state authorization, adjustment and reduction plans for defaulted local debts could be worked out under court supervision and enforced if creditors holding two-thirds of each class of a community's debt and three-quarters of the total debt

agreed. The measure was held unconstitutional in 1936⁸; a second Municipal Bankruptcy Act passed in 1937, similar in its general provisions to the 1934 law but limited to a three-year period of operation, was sustained by the courts.⁹

Against federal or state repudiation of debt, the bondholders have no remedy, since suit against the federal or state governments is a revocable privilege accorded by the governments themselves. Some possibilities of action are available in case of local defaults. In the New England states, bondholders can proceed against officials' and taxpayers' property. Elsewhere they may bring suit for mandamus orders to compel the levy of such taxes as are possible within constitutional or statutory limitations, to raise funds for debt service. But this remedy is generally more effective on paper than in practice. The mandamus order may compel the levy of a tax rate, but it cannot ensure collection, and the local tax officials may not be able to collect the levied rate—or may choose not to collect it.

“Credit” bonds

A “credit” loan may be defined as one for whose redemption no specific statutory provision is made. Bonds of such a loan may have a stated maturity—ten years, twenty years, or forty years—or they may be callable-term bonds, but nowhere on their face or in the act authorizing their issue is there provision for accumulating any fund for their redemption upon maturity. Such bonds rest flatly on the credit of the issuing government.

If a credit loan is small relative to the current budget of the borrowing government, a treasury balance sufficient to redeem the entire debt may be built up in preparation for the maturity date. But most bond issues are too large, relative to current governmental resources, to permit such practice. At best, credit loans are partly redeemed, partly refunded at maturity. At worst, when the due date occurs in a period of financial stringency, the debtor govern-

⁸ *Ashton v. Cameron County Water Improvement District*, 299 U.S. (1936) 619

⁹ *Lindsay-Strathmore Irrigation District v. Bekins* and *U.S. v. Bekins*, 304 U.S. (1938)

ment must acknowledge itself in real or technical default, and negotiate some sort of compromise arrangement with the bondholders.

When, as in the case of the federal government and some of the states and larger cities, an open market has been established for government debt issues, the debtor government may not have to wait until the maturity date to retire an issue. Current surpluses can be utilized to buy in parts of the issue. If the trends of interest rates and market values favor it, the debtor government may be able to purchase large blocks of its bonds below par, retiring its indebtedness at a profit. Lack of foresight in planning the terms of a bond issue, or unfavorable market and interest rate developments, however, may give the government no choice but to buy in its bonds at a premium. The federal government was in this position during the 1880's, when it was faced with a series of large treasury surpluses and no part of its Civil War debt was due for redemption or was callable. Such prior purchases of outstanding bonds, either at a discount or at a premium, may so reduce the outstanding total of an issue that only a small amount remains for retirement out of current funds at the maturity date.

Federal bond issues have always been, for all practical purposes, credit loans. True, from Hamilton's time down to the present, there has been a federal "sinking fund." But appropriations to the fund have generally been without discernible relation to the amount or maturity of the loans covered by the fund. In the past, all federal borrowings have been retired out of current surpluses, the sinking fund appropriations themselves being treated as a surplus element. The only real security behind federal bond issues is the Treasury's past debt record, which is perfect.

During the nineteenth century, state and local governments made frequent credit loans, with disastrous results. Rarely was preparation ever made for their redemption, and at maturity there could be no choice but to refund them for another period of years. State and local governments, it is now well recognized, cannot be trusted to issue credit bonds, and constitutions and statutes generally restrict them to the sinking fund and serial forms.

Sinking fund bonds

The principle of the sinking fund loan is simple. When a bond issue is floated, provision is made for paying a specified annual amount of tax or other revenue into a "sinking fund," which will be invested in various approved securities. Annual contributions to the sinking fund are so calculated that, at the maturity of the bond issue, the sum of the annual contributions plus interest on the investment of the sinking fund will exactly equal the amount of the bond issue to be retired. The principle of the sinking fund bond is commendable, and a state or local sinking fund bond will generally sell higher than a corresponding credit bond.

Sinking fund loans suffer, nevertheless, from serious practical defects. According to one authority, these are:

First, legislatures must be persuaded to make the annual appropriations regularly. If there is difficulty in balancing the budget and if the maturity date of the bonds is fifteen or twenty years in the future, legislators are likely to be indifferent on this point. Second, after the fund has been accumulated, the legislature, in difficult years, may be tempted to "raid" it; that is, borrow from it and fail to repay the loan. Third, the administration of a sinking fund requires much routine clerical work and a considerable degree of financial judgment to insure a fair return, to protect the principal, and to maintain a sufficient degree of liquidity so that cash will be available when needed. Finally, since these funds are outside the stream of current funds and are accumulated in large sums, they present a greater temptation to public officials who might be dishonest.¹⁰

Critics have generally condemned the federal sinking fund as inadequate to its purpose and unnecessary because of the federal government's sound debt retirement policy. Inadequate and unnecessary the federal sinking fund has undoubtedly been, viewed solely in relation to the total of federal debt and federal debt retirement policy, but it has served a useful purpose. It has caused part of the expense of federal debt retirement to be listed as current

¹⁰ Benjamin U Ratchford, *American State Debts* (Duke University Press, Durham, 1941), p 268, see also Chatters and Hillhouse, *op. cit.*, pp. 18-19.

expenditure, to be covered by current revenues. Thereby it has helped maintain federal tax rates against campaigns for tax reduction, thus making possible current surpluses for debt retirement. This consideration was very important during the 1920's, when popular sentiment was predominantly in favor of rapid reduction of war taxes rather than war debts.

The federal government and some state and city governments have made an important modification in the basic principle of the sinking fund. Instead of investing sinking funds in extraneous securities, they use funds to buy in portions of their own indebtedness whenever such bonds come into the general market. Bonds so purchased are canceled. Good sinking fund practice demands that the government thereafter pay into the sinking fund the value of the interest it would have had to pay during the life of the canceled bonds. This sinking fund procedure has the advantage of preventing the formation of fluid resources which may be raided subsequently by the borrowing government. As appropriations flow into the sinking funds, they are converted into bonds of the borrowing government, which are thereupon canceled. Where, as in many states, state or local debt limitations are based on gross rather than net debt, the immediate cancellation of bonds purchased by such sinking funds reduces the outstanding indebtedness of the issuing government and enlarges its future borrowing capacity. The accumulation of a sinking fund of the ordinary type would not have this effect.

This "self-obliterating" sinking fund, unfortunately, has a limited application. It can be used only by government units having so large a total of outstanding indebtedness that their bonds are readily purchasable in the general market. The federal government can have resort to it, as can a few of the states and the larger cities, but it is not available to the great majority of state and local governments.

Serial bonds

By providing for the retirement of a bond issue in annual instalments, the necessity of a sinking fund can be avoided. This serial

retirement is the characteristic of the serial bond. If all instalments of principal are equal, the government's payments for debt service will be heavier during the earlier years of the loan when interest payments are heaviest. Instalments of the principal can, however, be adjusted to payments of interest so that the annual payments for total debt service are nearly uniform. This possibility is indicated in Table 32:

TABLE 32

UNIFORM DEBT SERVICE PAYMENTS ON A FIVE PER CENT
\$500,000 TWENTY-YEAR SERIAL LOAN

| Year | Amount Outstanding | Principal Retired | Interest Payment | Total Debt Service |
|-------------------|-----------------------|----------------------|---------------------|-----------------------|
| 1 | \$500,000 | \$15,000 | \$25,000 | \$40,000 |
| 2 | 485,000 | 16,000 | 24,250 | 40,250 |
| 3 | 469,000 | 17,000 | 23,450 | 40,450 |
| 4 | 452,000 | 18,000 | 22,600 | 40,600 |
| 5 | 434,000 | 19,000 | 21,700 | 40,700 |
| 6 | 415,000 | 20,000 | 20,750 | 40,750 |
| 7 | 395,000 | 21,000 | 19,750 | 40,750 |
| 8 | 374,000 | 22,000 | 18,700 | 40,700 |
| 9 | 352,000 | 23,000 | 17,600 | 40,600 |
| 10 | 329,000 | 24,000 | 16,450 | 40,450 |
| 11 | 305,000 | 25,000 | 15,250 | 40,250 |
| 12 | 280,000 | 26,000 | 14,000 | 40,000 |
| 13 | 254,000 | 27,000 | 12,700 | 39,700 |
| 14 | 227,000 | 28,000 | 11,350 | 39,350 |
| 15 | 199,000 | 29,000 | 9,950 | 38,950 |
| 16 | 170,000 | 30,000 | 8,500 | 38,500 |
| 17 | 140,000 | 33,000 | 7,000 | 40,000 |
| 18 | 107,000 | 34,000 | 5,350 | 39,350 |
| 19 | 73,000 | 36,000 | 3,650 | 39,660 |
| 20 | 37,000 | 37,000 | 1,850 | 38,851 |
| Total | | \$500,000 | \$299,850 | \$799,850 |
| Annual average | | \$ 25,000 | \$ 14,992.50 | \$ 39,992.50 |

From Chatters and Hillhouse, *op cit*, p. 21

As a method of state or local finance, the serial bond is free from the disadvantages of the sinking fund bond. When serial bonds were new, they sold somewhat lower than corresponding

sinking fund bonds. Investors, it was then argued, did not care for the first short-term instalments of serial bond issues, and serial bonds would therefore prove more expensive to market than sinking fund bonds. Four decades' experience has shown that initial unfamiliarity rather than form accounted for early market antagonism toward serial bonds, and today such bonds sell on an equality with or higher than sinking fund bonds. About 85 per cent of state bonds issued during the 1920's and 1930's were in serial form. Many debt limitation laws now require local bonds to be issued in serial form.

Other elements of security

If a government's credit is weak, it may have to earmark various revenues to debt service in order to reassure purchasers of the bonds. Foreign loans floated in this country during the 1920's were frequently backed by such earmarkings. The federal government has never found it necessary to resort to such extraneous buttressing of its issues. Constitutional provisions frequently require state and local governments, regardless of their current credit standing, to impose tax levies sufficient to cover debt service on the occasion of floating any bond issue.

The Liberty Loans and Treasury bonds sold during the 1920's all carried a "gold clause"—an obligation to pay principal and interest on the loan in gold coin "of the current weight and fineness." So did many state and local bonds of the 1920's. When these bonds were issued, the clause was rather meaningless. There was not the slightest indication that any suspension of gold payments on other elements of the currency system would or could occur. For most if not all purchasers of these bonds, the circumstance that they were "gold" bonds was an unimportant flourish. But when the dollar was devalued in terms of gold in 1933, this "gold clause" in government bonds became abruptly important—if enforceable, it would give every bondholder a 69 per cent premium in current dollars. Congress had specifically voided all "gold clauses" by a joint resolution of June 5, 1933, but doubts as to its

validity were current. In 1935, however, the Supreme Court held ¹¹ that though the "gold clause" in federal bonds was a binding contract and could not be voided by Congressional action, it was in practice unenforceable, since to sustain their suits bondholders would have to show monetary loss—and from the nature of dollar devaluation, no loss in monetary terms could be established. Subsequently outlawry of federal "gold clause" suits by Congressional action placed the issue beyond reach of further judicial intervention. The original Congressional resolution was fully valid as to "gold clauses" in state and local bonds, however, since the currency powers of Congress override all other arrangements for monetary payments.¹²

As previously indicated, local governments have a much worse record of defaults than the state governments. This affects the estimate of safety that investors attribute to all local issues, even those of governments with clear records. Furthermore the relatively limited bases of wealth and taxable capacity behind local issues as contrasted with state issues lowers the "safety" factor of all local issues. Consequently, local issues in general must be sold at a higher yield than comparable state issues. It has been suggested in recent years that a considerable saving in local interest payments could be effected if the states would underwrite the issues of their local units, and thus substitute their own superior credit standing for that of the localities. A more extreme proposal to the same effect is that the states themselves purchase the issues of their localities, and sell their own bonds to raise the needed funds.

State underwriting of local debt issues would have to be tied up with some degree of state control of local borrowing.¹³ State governments could not fairly be saddled with every debt issue put out by irresponsible local units. The directors of the state "local debt fund" would have to be given discretion as to acceptance or rejection of local issues, taking into consideration both the purposes of

¹¹ *Perry v U S*, 294 U S (1935) 330

¹² By implication from *Norman v B & O. Rr.*, 294 U S (1935) 240.

¹³ See p 634 of this volume

the issue and the resources of the community. Such discretion would inevitably involve control over local functions. Even were the borrowing unit free, after the rejection by the state fund, to offer its issue through regular market channels, knowledge of the prior rejection would probably make it unmarketable except at exorbitant rates. This element of state control must damn the proposal for those who resent state control of local governmental activity in any form whatsoever. For those to whom state control is a *desideratum per se*, this circumstance will be a further recommendation for state underwriting.

TAX EXEMPTION AND OTHER "BONUS" INCIDENTS

If special privileges or profits are attached to government debt issues, such issues may reach markets which would otherwise be closed to them, and they can be sold at lower yields. An extreme example of special profit attached to government bonds is the lottery prize drawing with which a few foreign governments have sought to "sweeten" some issues. In this country only two extraneous privileges have ever been associated with government bond ownership—tax exemption and the "currency privilege."

Basis and extent of tax-exempt bonds

As previously stated,¹⁴ constitutional principles were formerly held to bar the federal government from taxing interest on state and local bonds, and the state and local governments from taxing the capital value of federal bonds or the interest on them. Furthermore, the federal government has partly or wholly exempted interest on its own issues and on the issues it guarantees from the federal income tax. Many, possibly most, of the bonds issued by state and local governments since World War I have carried exemption from the property or income taxes of the states wherein they were issued. This privilege, of course, does not extend beyond the boundaries of the issuing state, and if such bonds are held by residents of another state, they are fully subject to the tax laws of that state.

¹⁴ See pp 208 and 219 of this volume

As of June 1940, interest on \$54,800,000,000 of outstanding bonds, not including any held by governmental agencies, was wholly or partially exempt from the federal income tax. Of this stupendous total, \$39,400,000,000 were federal issues and guaranteed issues of various federal agencies, and \$15,400,000,000 were state and local issues. Most of these bonds were also exempt as to their principal from state and local property taxes, and as to their interest from state income taxes.

Fiscal and social effects of tax-exempt bonds ¹⁵

Exemption of the interest on a bond from federal and state income taxation, and exemption of its capital value from state and local property taxation, unquestionably make it more valuable to a holder liable for such taxes. Such a holder will be willing to pay more for a tax-exempt bond, through accepting a lower yield, than for a taxable one. The maximum yield that he will sacrifice will be the amount of his tax saving. Of course, if he is able to buy at a better price—i.e., at a yield whose difference from the yield of comparable taxable securities is less than his tax saving—he will do so. The primary point of dispute presented by tax-exempt bonds is whether the amount that the bond-issuing governments save by issuing tax-exempt securities at lower yield rates is more or less than the amount that the taxing governments lose through inability to tax these bonds or their interest. If the gain of the issuing governments is greater than the loss of the taxing governments, then, from a fiscal view at least, tax-exemption is justified. If the loss of the taxing governments is greater than the gain of the issuing governments, there is no fiscal warrant for tax-exempt bonds.

It might seem, at first thought, impossible to argue that bond-issuing governments could gain more from tax-exempt securities than the taxing governments lose. This would imply that some

¹⁵ The fullest discussion of the issue is found in 76th Congress, 1st Session, Special Committee on Taxation of Governmental Securities and Salaries, *Hearings* (1939), and 76th Congress, 1st Session, Committee on Ways and Means, *Hearings on the Taxation of Governmental Securities* (1939), see also William J. Shultz, "Tax Exemption of Governmental Securities," *Taxes*, June 1939, pp 1-7, and "The Proposal to Tax Income from Governmental Securities," *Law and Contemporary Problems*, Spring, 1940, pp 217-221

bondbuyers were willing to pay more for the exemption privilege than it was worth to them in tax saving. Yet this proposition has been advanced by a noted tax authority,¹⁸ and an interesting argument can be developed in support of it. There are two competing demands for tax-exempt bonds—(1) the demand of personal and corporate investors to whom the exemption privilege is valuable and who are interested primarily in yield, and (2) the demand of institutions and trust funds that have little interest in the exemption privilege but are willing to accept a lower yield to insure the maximum of safety for their investments. According to the writers who argue that there is a fiscal gain in tax-exempt securities, the price or yield rate—and hence the gain to the issuing governments—is determined primarily by the first group of bondbuyers, they probably pay somewhat less for the exemption privilege than they save in taxes, so that there is a slight fiscal loss on sales made to them. The second group of bondbuyers, however, also buy at the lower yield rate established by the first group. Since they save little by the tax exemption, the taxing governments lose little, and there is a substantial fiscal profit on total sales.

This ingenious argument rests on the proposition that the market price of tax-exempt securities—in terms of yield—is determined by the group of purchasers to whom such exemption is of greatest value. Such a proposition is contradicted by all theories of price determination. The value of tax exemption, like that of any commodity or service, is subject to the law of diminishing utility. To the multimillionaire paying an 81 per cent tax on the excess of his income over \$5,000,000, tax exemption is worth four-fifths of the yield from his investment. If only a few hundred million dollars of tax exempt securities were in existence, they would all be bought by multimillionaires who would be willing to buy them though their yield was less than a quarter that of comparable taxable securities. With more tax-exempt securities in existence than are needed to meet the

¹⁸ Harley L. Lutz, "The Fiscal and Economic Aspects of the Taxation of Public Securities," in Special Senate Committee on Taxation of Governmental Securities, *Hearings*, pp. 91-186.

demand of the multimillionaires, new issues must be sold to people and institutions for whom their utility is less. They must be sold to individuals with \$50,000 incomes for whom their utility, as determined by the federal income tax schedule, is less than a three-fifths reduction of yield; they must be sold to corporations for whom their utility, under the corporation income tax, is worth less than a 24 per cent reduction in yield; they must be sold to small trust accounts and to people with small incomes who are looking for absolute safety in their investments, for whom their utility is worth only a 20 per cent, or 15 per cent, or 10 per cent reduction in yield; they must be sold to government sinking funds and to charitable and educational foundations which are exempt from federal income taxation and which gain nothing from tax exemption. For any particular supply of a commodity or service offered for sale, the price is determined by the marginal buyers—the group farthest down the utility scale, to whom the item must be sold to market the entire supply. With over \$50,000,000,000 of tax-exempt securities now available, new issues must be sold to people and institutions for whom the exemption is worth very little, and who therefore offer very little in the way of lower yield to obtain such securities. This conclusion is borne out by Table 33, which shows the distribution of tax-exempt securities by holders as of 1940. The volume of tax-exempt securities in relation to the demand for exemption of investment income has forced tax exemption almost into the category of a “free good” which cannot command a price. Certainly the yield differential which can be attributed to it at present is trifling, probably less than the 0.4 per cent which Treasury economists calculated in 1939.¹⁷

To whatever extent tax-exempt securities can still command some slight yield differential, they are advantageous to the issuing governments. But this advantage is overwhelmingly offset by the losses incurred by the taxing governments. Counting issuing and taxing

¹⁷ The Treasury economists attributed to tax exemption certain elements of “yield reduction” that can better be accounted for by the greater security of government bonds and the special demand created for these by the “legal lists” for savings bank and trust fund investment.

governments together, tax-exempt securities at present involve the country in an annual net fiscal loss between \$200,000,000 and \$300,000,000.

Such fiscal loss from tax exemption is not a continuing uniform

TABLE 33
TAX-EXEMPT SECURITIES, BY CLASSES OF
PRIVATE HOLDERS, JUNE 30, 1940
(Billions of dollars)

| Class of Security | Held by Com- mercial Banks | Held by Insur- ance Com- panies | Held by Other Corpo- rations | Held by Tax- exempt Institu- tions | Held by Indi- viduals | Total |
|--------------------------------|-------------------------------------|---|---------------------------------------|--|-----------------------------|--------|
| <i>Wholly tax-exempt</i> | | | | | | |
| Federal | \$ 3 7 | \$ 4 | \$ 6 | \$ 4 | \$ 1 8 | \$ 6 9 |
| Federal instru- mentalities | 3 | | 1 | | 9 | 1 3 |
| State and local | 3 6 | 2 1 | 5 | 1 3 | 7 9 | 15 4 |
| Total | \$ 7 6 | \$2 5 | \$1 2 | \$1 7 | \$10 6 | \$23 6 |
| <i>Partially tax-exempt</i> | | | | | | |
| Federal | \$ 9 5 | \$5 2 | \$1 0 | \$2 7 | \$ 7 5 | \$25 9 |
| Federal instru- mentalities | 3 6 | 5 | 2 | 6 | 4 | 5 3 |
| Total | \$13 1 | \$5.7 | \$1.2 | \$3 3 | \$ 7 9 | \$31 2 |
| Total tax-exempt | \$20 7 | \$8 2 | \$2.4 | \$5 0 | \$18 5 | \$54 8 |

Derived from United States Secretary of the Treasury, *Annual Report, 1940*, pp 812-813.

amount, but varies according to a number of circumstances. (1) The more the volume of tax-exempt securities outstanding increases, the greater is the relative as well as absolute loss. The tax-exemption privilege comes to be worth less; hence the issuing governments obtain a smaller "yield reduction" profit to offset the losses sustained by the taxing governments. (2) If market interest rates decline, the "yield reduction" profit of the governments issuing tax-exempt securities shrinks in proportion; consequently there is less gain on their part to offset the loss of the taxing governments and the total

net fiscal loss is greater. Contrariwise, if market interest rates rise, the total net fiscal loss is reduced. (3) If tax rates rise, the net fiscal loss is increased, since the "yield reduction" profit originally obtained by issuing governments on tax-exempt securities was based on the earlier lower tax saving, and there is nothing to offset the subsequent greater tax loss of the taxing governments. Contrariwise, if tax rates are reduced, the net fiscal loss is decreased.

Besides this primary fiscal objection to tax-exempt bonds, such bonds have three secondary fiscal and economic disadvantages (1) They reduce the effective progression of the federal and state income tax schedules, by providing a legal means of avoiding the higher rates of the upper brackets. (2) Tax exemption induces rich men to place capital not employed in business operation or control in the security of government issues, whereas this is the very capital that should, from the viewpoint of the economic advantage of the nation, be active in venturesome operations. (3) To the extent that tax exemption commands any yield differentiation, trust funds, foundations and others that seek the safety of government securities but have no interest in the exemption privilege are compelled to accept a lower return on their investments.

Abolition of tax-exempt bonds

Elimination of the tax exemption privilege of government bonds involves two separate procedures. (1) Upon their own independent administrative or legislative initiative, the federal government must cease issuing securities whose interest is exempt from its own taxes, and the states must provide that their bonds and those of their local units shall no longer be exempt from their own state and local taxes. (2) Federal tax laws must be applied to the interest on state and local issues, and state and local tax laws must be made applicable to federal issues.

Neither the federal nor the state governments should consider applying their taxes to any of their own securities previously issued as tax-exempt. Provision for the exemption of these bonds and their interest from taxation was a solemn covenant binding upon the issuing governments, and to repudiate it would do irreparable injury to

their credit. Furthermore, the state and local governments are prohibited under the federal Constitution from impairing the obligation of contracts, including their own. Only the future issue of tax-exempt bonds can be stopped. Until very recently the federal and state governments have hesitated to take the simple step of issuing new securities on a taxable basis, because of the mistaken view that they were obtaining a net fiscal profit on their own tax-exempt issues. This view is waning. Since the spring of 1941 the federal Treasury has been issuing securities whose interest is taxable under its own laws. In a scattered but increasing number of cases, state and local governments are taking the same step. Since, however, a local government can still make a small gain by issuing its bonds as exempt from state taxes, though at a substantial loss to the revenue system of its state if that system provides for taxation of the interest or principal of local issues that carry no tax-exempt clause, it will be necessary for the states to withdraw the privilege of issuing tax-exempt bonds from their local units before the reform can become universal.

Subjecting the interest on state and local bonds to federal income taxation, and the capital and interest of federal securities to state and local taxes, involves different issues. Until 1939 the "state instrumentalities" and "federal instrumentalities" limitations¹⁸ seemed to establish categorical bars against mere legislative action in these directions. A constitutional amendment repealing these limitations seemed the most direct solution to the problem. Such a proposed amendment was approved by the House in 1923, but failed of passage in the Senate. Even had both Houses passed such an amendment, however, it could never have obtained ratification by three-quarters of the states, since they and their local units were gaining by tax exemption at the expense of the federal government. A second suggestion, which was advanced in earlier editions of this study, was that the federal and state governments might take advantage of the "subject-measure" rule of judicial construction,¹⁹ and include

¹⁸ See pp 208 and 219 of this volume

¹⁹ See p 202 of this volume

the income of government securities in taxes "measured" by income whose "subject" was the "act or privilege of receiving income." Several states took this step in their bank and corporation income taxes. Now, however, the bar of the "state and federal instrumentalities" limitations has apparently been brushed aside by the Supreme Court. While no decisions have been made on taxing the interest on government securities because such tax laws have not heretofore been in existence, most tax lawyers believe that recent cases on the taxation of governmental salaries have opened wide the door to nondiscriminating taxation of governmental interest.

Though Congress probably can direct the application of the income tax to the interest on state and local bonds—outstanding issues as well as future ones—and the state legislatures can reach interest on federal bonds, there is great hesitancy to take this step. Local governments feel that they would have to market their bond issues at higher yield rates if the interest were taxable. Undoubtedly they would, though for propaganda purposes they have exaggerated the difference. Their little advantage is gained at the cost of a much greater revenue loss to the federal government, but none the less it is *their* advantage, and they are fighting to retain it. Their lobby has probably been the principal factor in delaying Congressional action on the issue since the Supreme Court opened the door to legislative procedure. Meanwhile, the state legislatures have been very careful not to tax federal securities, so that Congress will have no provocation on that score to tax state and local issues.

Still open is the question whether federal taxation of the interest on state and local bonds, and the corresponding state and local taxation of federal securities, should be limited to new issues or should apply to all issues outstanding. To apply a tax to outstanding securities and their interest would be cheating, say opponents of the proposal, since the bonds were bought at yield-prices that took exemption into account. Proponents argue that the states and local governments never had any authority to promise that their bonds would be exempt from federal taxation, nor could the federal government ever make a corresponding promise concerning its issues.

Investors who bought in reliance upon judicial interpretation of a constitutional presumption, and who find that reliance unfounded, are in no different position from countless others who have suffered loss because of court rulings; all business and investment commitments are subject to the law as construed by the courts and to changes in the law so construed. Furthermore, argue the proponents of elimination of exemption of all securities, failure to tax outstanding issues will in time make the exemption privilege of unmatured present tax-exempt securities ever more valuable as the supply of exempt securities dwindles, and thus will bestow an unearned increment on their holders. And finally, there will be little fiscal gain for a long time to come if the present mass of tax-exempt issues remains untouchable until their maturity.

The "currency privilege"

New York's "free banking" law of 1838 provided that state bank notes must be secured by equivalent value of New York State bonds, federal bonds, or certain other specified securities deposited with the state comptroller. By 1860, sixteen states had "free banking" laws. These laws, it was soon realized, intensified banking demand for the specified security issues, and enabled their sale on more favorable terms. Consequently, nearly all "free banking" laws eventually provided that the bonds of the legislating states or of their subdivisions were the only acceptable security for bank notes. The "currency privilege" of state bonds in these states became valueless when the federal government taxed state bank notes out of existence in 1867.

The National Banking Act of 1863 made federal Civil War bonds the required security for national bank notes, thereby establishing a bank note currency as sound as the credit of the federal government itself and at the same time assuring the federal government of an important new and lasting market for its bonds. This "currency privilege" was attached to all subsequent federal bond issues through 1900, and to some of the later Panama Canal bonds. In 1932, as an antidepression measure, "currency privilege" was temporarily extended to some \$1,000,000,000 of Liberty and Treasury bonds bearing $3\frac{3}{8}$ per cent interest or less. This temporary "currency

privilege" expired in 1935. In that year the Treasury retired all "old privilege" bonds still outstanding, with specific intent to wipe out the circulation of national bank notes. At present indication, "currency privilege" as a feature of American bond issues has become an episode of the past.

CHAPTER XXVIII

History and Status of American Governmental Debt

WITH the exception of the federal government's Civil War loans, borrowing and debt were relatively unimportant features of American public finance until the twentieth century. The \$2,834,000,000 of debt outstanding in 1902—nearly two-thirds of it local debt—amounted to only \$35.69 per capita, and bore a ratio to the nation's wealth of only 2.6 per cent. No other leading world power could boast of so moderate a governmental mortgage on its future.

After 1900 problems of public borrowing and indebtedness assumed a prominent place in the American fiscal picture. From 1900 through 1916 local governments borrowed large amounts for construction of highways, schools, and public buildings. Between April 1917 and November 1919 the federal government issued over \$24,000,000,000 of war debt securities. Federal debt was reduced by nearly \$10,000,000,000 during the next eleven years, but state and local debt increased by a larger sum; in 1930, the gross total of American governmental debt stood close to \$34,000,000,000. Local borrowing after 1931 fell off to a trifling amount. In fact, local debt retirement during 1934 was greater than new local borrowing. But state borrowing continued in substantial amount throughout depression and recovery. Between June 1930 and March 1933, the federal government borrowed \$4,700,000,000 to cover current deficits caused in part by a decline of revenues, in part by RFC advances and other antidepression expenditures. And the Roosevelt "recovery" and "relief" programs necessitated a \$22,000,000,000 increase in the federal debt during the next seven years. As of 1940, the total gross governmental debt was \$62,862,000,000. Federal deficits resulting from the development of the national defense program after the summer of

TABLE 34

AMERICAN GOVERNMENTAL DEBT, SELECTED YEARS 1790-1941
(Amounts in millions)

| Year | Gross Debt | | | | Per Capita Debt | Per Cent Ratio to National Wealth | Per Cent Ratio to Total American Debt |
|------|---------------------------------|----------|--------|--------|-----------------------|--|---|
| | Federal Interest- bearing | State | Local | Total | | | |
| 1790 | \$ 75 | 1 | 1 | 1 | 1 | 1 | 1 |
| 1800 | 83 | 1 | 1 | 1 | 1 | 1 | 1 |
| 1810 | 48 | 1 | 1 | 1 | 1 | 1 | 1 |
| 1820 | 90 | 1 | 1 | 1 | 1 | 1 | 1 |
| 1830 | 39 | \$ 26 | 1 | 1 | 1 | 1 | 1 |
| 1840 | 5 | 175 | \$ 20 | \$ 195 | \$ 11 40 | 1 | 1 |
| 1850 | 68 | 190 | 27 | 285 | 12 28 | 4 0 | 1 |
| 1860 | 90 | 257 | 200 | 547 | 17 45 | 3 3 | 1 |
| 1870 | 2,353 | 353 | 516 | 3,222 | 83 47 | 13 4 | 1 |
| 1880 | 2,055 | 275 | 849 | 3,179 | 63 33 | 7 3 | 1 |
| 1890 | 852 | 211 | 926 | 1,989 | 31 62 | 3 1 | 1 |
| 1902 | 969 | 235 | 1,630 | 2,834 | 35 69 | 2 9 | 14 1 |
| 1912 | 1,028 | 346 | 3,477 | 4,851 | 51 01 | 2 6 | 13 3 |
| 1919 | 25,482 | 694 | 6,348 | 32,524 | 309 74 | 1 | 43 1 |
| 1922 | 22,964 | 1,163 | 8,730 | 32,857 | 299 05 | 10 7 | 37 5 |
| 1926 | 19,643 | 1,858 | 11,806 | 33,307 | 287 82 | 10 3 | 31.4 |
| 1930 | 16,185 | 2,444 | 15,541 | 34,130 | 277 63 | 9 7 | 27.7 |
| 1932 | 19,487 | 2,896 | 16,434 | 38,817 | 310 93 | 12 6 | 31 1 |
| 1935 | 28,701 | 3,395 | 15,127 | 47,673 | 374 64 | 16 3 | 42 3 |
| 1937 | 36,427 | 3,276 | 15,876 | 55,579 | 431 44 | 17 6 | 43 2 |
| 1938 | 37,117 | 3,301 | 15,919 | 56,337 | 433 95 | 18 2 | 43 0 |
| 1939 | 40,445 | \$19,626 | | 60,071 | 458 99 | 1 | 44 7 |
| 1940 | 42,971 | 19,891 | | 62,862 | 476 41 | 1 | 1 |
| 1941 | 48,961 | 1 | | 1 | 1 | 1 | 1 |

¹ Not availableDerived from Paul Studensky, *Public Borrowing*, p 13, and The Conference Board, *The Economic Almanac for 1941-42* (the Board), pp 325, 355, 362

1940 increased federal debt, and with it the total of governmental debt, even more rapidly than during the 1930's.

Many current books and articles are posing the question of whether the total of American public debt—particularly the federal debt—has not reached the proportions of menace. Were there some economic "safety limit" for governmental borrowing, the question

could be answered, but though many dangers of excessive public debt accumulation can be pointed out, no figure can be given beyond which further debt becomes "excessive." In this connection it may be pointed out that in 1936 both England and France were carrying heavier debt burdens than the United States. Per capita governmental debt in England was \$896, and in France \$457, as against

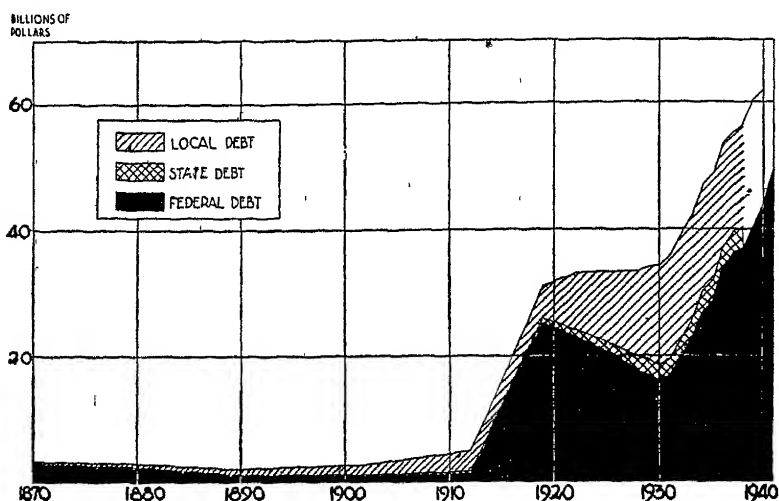


CHART XIV AMERICAN GOVERNMENTAL DEBT, 1870-1940

\$388 for the United States. The ratio of governmental debt to national wealth was 47.6 per cent for England, 41.0 per cent for France, and 16.6 per cent for the United States.¹ England, with the highest debt burden, had managed her debt without producing a financial crisis. In France, a smaller public debt was a contributing factor to the financial misadventures which unsettled that country during the 1920's and 1930's.

THE FEDERAL DEBT

Since its creation, the federal government has been free of debt for only one year—the fiscal year 1835-1836. At all other times it

¹ The public debt and wealth figures utilized for these calculations, from Twentieth Century Fund, *The National Debt and Government Credit* (New York, 1937), are at some variance from those in Table 34. But they establish a uniform basis of comparison between the three countries under consideration.

has been engaged either in borrowing to meet emergencies of one sort or another, or in carrying the debt so incurred, or in retirement operations. Prior to 1917, the Treasury's methods of borrowing or debt management displayed little of science or skill. The tremendous volume of World War I borrowings presented the Treasury with a debt problem for which disaster would have been the penalty of unskilled handling. Fortunately, since 1917 a succession of able Treasury officials have managed the federal debt in masterful fashion, and their accomplishments have written a brilliant page in federal fiscal history.

Federal debt history, 1790-1917

At the outset of its career, the federal government borrowed \$170,000 from the Banks of North America and New York for the first instalments on the salaries of the President, the Vice-President, and members of Congress, and for certain other vital expenses. By 1796 it had issued over \$75,000,000 of "stock"—as government bonds were then called—to cover the assumption and funding of the Revolutionary debt of the Continental and state governments. Over \$7,000,000 was borrowed through three loans in 1789 to equip the army and navy and to fund accumulated deficits. Another \$15,000,000 loan in 1803 financed the purchase of the Louisiana territory. From 1801 through 1811, however, the Republican administration bent its efforts to debt reduction, retired \$39,000,000, and left only \$45,000,000 outstanding by the close of 1811.

Borrowing again became necessary to finance the War of 1812. The country was not wholeheartedly behind the war, the Treasury was ineptly managed, and federal credit sank to a low ebb. A series of 6 per cent loans had to be sold at such discounts that on \$51,000,000 par value the government received only \$45,000,000. Immediately after the war, the Treasury set itself to the task of retiring this debt, and by 1835 it had succeeded in so doing. The onset of depression in 1837 resulted in Treasury deficits which were covered by issues of Treasury notes. Three issues of bonds in the early 1840's were placed with extreme difficulty, the market having become unfamiliar with federal bonds. By the Mexican War period, however,

federal credit standing was high, and Treasury offerings of 6 per cent bonds were oversubscribed and sold at a premium.

Because of official and Congressional overoptimism, the Union government financed nearly three-fourths of its Civil War costs by borrowing. During the first two years, poor Treasury judgment in setting bond terms and the lack of enthusiasm for the war among investing classes practically closed the market for long-term bonds, and the Treasury issued \$450,000,000 of "greenbacks"—Treasury notes in currency denominations—and accumulated \$250,000,000 of floating debt. Later bond-selling efforts were more successful. By the close of the war, over \$1,000,000,000 of callable-term bonds, nearly \$900,000,000 of intermediate-term issues, and over \$650,000,000 of currency issues and floating debt, were outstanding.

Immediately after the war, the short-term and due intermediate-term debt was refunded into 6 per cent callable-term bonds, and in 1871, over \$200,000,000 of "callable" 6 per cent debt was refunded with a 6 per cent issue. From 1870 on, the Treasury followed a policy of retiring outstanding debt with current surpluses. All callable bonds had been redeemed by the 1880's, and during that decade the Treasury bought in nondue bonds at a substantial premium. By 1890 outstanding debt was reduced to \$852,000,000.

Five years later, \$200,000,000 of bonds were floated to purchase gold for the Treasury reserve. Another \$200,000,000 issue, this time at 3 per cent, was sold in 1898 to help finance the Spanish War. Between 1904 and 1916 approximately \$135,000,000 of bonds were issued for the construction of the Panama Canal. These issues brought the federal debt to slightly over \$1,000,000,000 in 1909, at which figure it remained until the entry of the United States into World War I.

World War I borrowing

Between 1917 and 1920 the federal Treasury negotiated one of the supreme financial transactions of modern times. Through brilliant management and appeal to patriotic sentiment, it borrowed over \$25,000,000,000 without disrupting the country's financial organization. The First Liberty Loan, \$2,000,000,000 of tax-exempt 3½ per

cent bonds, was sold in April 1917 on a wave of popular enthusiasm, and was oversubscribed 52 per cent. Six months later the Second Liberty Loan, \$3,000,000,000 of partially tax-exempt 4 and 4¼ per cent bonds, was oversubscribed 54 per cent. A third Liberty Loan of \$3,000,000,000 and a fourth of \$6,000,000,000 were marketed and heavily oversubscribed in 1918. The last of the war loans, the \$4,500,000,000 intermediate-term Victory Loan, was floated in May 1919.

War loan and tax receipts were received in large lump sums on the five bond sale dates and on the various tax dates. Expenditures, on the contrary, were continuous, and to bridge the gaps between continuous expenditures and irregular receipts, the Treasury issued short-term certificates of indebtedness. During the war period, the retirement of these short-term certificates never caught up with the new issues, and by August 31, 1919 over \$4,000,000,000 were outstanding. On this date, the peak point for federal war debt, the gross total inclusive of matured items stood at \$26,358,692,171.26.

Debt retirement, 1919-1930

By the fall of 1919, revenues were running ahead of expenditures, and the Treasury's problem changed from one of borrowing to one of debt retirement. As an aftermath of its war financing, the Treasury had a large cash balance in the fall of 1919. Between August 1919 and July 1920 it utilized over \$500,000,000 of this balance, another \$560,000,000 surplus revenue for fiscal year 1919-1920, and some later receipts from Victory Loan sales to retire \$1,400,000,000 of its floating debt. But the cash balance of 1919 was an exceptional source of debt retirement funds, and after 1920 such funds were secured from four other sources—sinking fund appropriations, certain items of internal revenue, foreign debt payments made in federal securities, and annual surpluses.

At the time the Liberty Loans were authorized, Congress provided for a federal "sinking fund." As revised by the Victory Loan Act, the principal income of this "fund" was an annual appropriation equal to 2½ per cent of the ten billion dollar "domestic" debt—the value of the Liberty and Victory Loan bonds and notes outstanding on July 1, 1920 minus the par value of the Allied debt to the

American government. To this basic appropriation was added the interest payable on all securities retired through the fund. Because of this last provision, the sinking fund appropriation increased each year; in 1921 it was \$256,000,000, in 1930 \$383,000,000.

The items of federal internal revenue earmarked to debt retirement are insignificant. Federal bonds received in payment of the federal estate tax and by forfeiture or gift are immediately canceled. Receipts from the federal reserve franchise tax and the net earnings from the intermediate credit banks are also devoted to debt retirement. In all, during the 1920's, these items retired less than \$240,000,000 of federal debt.

During and immediately after World War I the federal government lent nearly \$9,500,000,000 to its allies. Funding agreements negotiated between 1922 and 1926 established a due principal, covering original principal and unpaid interest, of \$11,700,000,000. The agreements provided for annual principal and interest payments running to 1987, that totaled over \$22,000,000,000. Great Britain was to pay over half of this total, and France and Italy, four-fifths of the remainder. Payments might be made by remittance or in federal bonds. Important in the Treasury's arrangements for retiring the federal debt was the unbroken continuance of these foreign debt payments. It was more or less taken for granted that \$11,000,000,000 or more of the federal debt would be retired from foreign debt payments, leaving only the balance as a burden upon American taxpayers. During the 1920's, when the Treasury received \$2,200,000,000 of foreign debt payments, this expectation seemed warranted. Over \$1,000,000,000 of these payments were made in the form of federal bonds, bought at prices below par by the debtor governments, and immediately retired upon receipt by the Treasury. The \$460,000,000 of cash payments of principal were also applied directly to debt retirement. Cash payments of interest, counted as current receipts, swelled the current surpluses available for debt retirement.

By far the most important source of debt retirement during the 1920's was the series of annual surpluses. In every year from 1920 through 1930, federal receipts considerably exceeded federal ex-

TABLE 35
FEDERAL DEBT OUTSTANDING, JUNE 30, SELECTED YEARS 1920-1941

| | 1920 | 1923 | 1926 | 1928 | 1930 | 1932 | 1934 | 1936 | 1938 | 1940 | 1941 |
|---|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|----------|
| <i>Amounts by Maturity Types (in millions)</i> | | | | | | | | | | | |
| Old debt and postal savings | \$ 884 | \$ 884 | \$ 766 | \$ 768 | \$ 773 | \$ 790 | \$ 831 | \$ 200 | \$ 197 | \$ 196 | \$ 196 |
| Bonds | 16,162 | 15,988 | 16,163 | 12,253 | 11,339 | 13,460 | 15,679 | 18,195 | 23,905 | 30,224 | 35,270 |
| Notes.. | 4,246 | 4,104 | 1,612 | 2,900 | 2,390 | 1,465 | 6,932 | 11,861 | 10,425 | 8,936 | 9,027 |
| Short-term debt . | 2,769 | 1,032 | 843 | 1,397 | 1,420 | 3,446 | 3,039 | 2,499 | 2,052 | 3,023 | 3,895 |
| Matured debt . | 7 | 98 | 13 | 45 | 32 | 60 | 54 | 169 | 141 | 205 | 205 |
| Gross total | \$24,068 | \$22,106 | \$19,397 | \$17,363 | \$15,954 | \$19,221 | \$26,535 | \$32,925 | \$36,720 | \$42,585 | \$48,593 |
| Held by governmental agencies in trust funds | | | 204 | 462 | 764 | 309 | 396 | 626 | 2,676 | 4,775 | 6,120 |
| Net total | \$24,068 | \$22,106 | \$19,193 | \$16,901 | \$15,190 | \$18,912 | \$26,139 | \$32,299 | \$34,044 | \$37,810 | \$42,473 |

Percentage Distribution of Interest-Bearing Debt Exclusive of Trust Fund Issues, by Interest Rates

| Under 1% | | | | | | | | | | | |
|--------------|--|--|--|--|--|--|--|--|--|--|--|
| 1 1/2-1 1/2% | | | | | | | | | | | |
| 1 1/2-2% | | | | | | | | | | | |
| 2 1/2-3% | | | | | | | | | | | |
| 2 1/2-3 1/2% | | | | | | | | | | | |
| 3 1/2-4% | | | | | | | | | | | |
| 3 1/2-4 1/2% | | | | | | | | | | | |
| 4 1/2-5% | | | | | | | | | | | |
| 5 1/2-6% | | | | | | | | | | | |
| 5 1/2-6 1/2% | | | | | | | | | | | |
| Total | | | | | | | | | | | |

¹ Unavailable

Derived from United States Secretary of the Treasury, *Annual Reports*

penditures. The lowest of these surpluses, \$86,724,000, occurred in 1921; the highest, \$635,810,000, in 1927. In 1926 and in 1928 Congress faced the alternatives of tax reduction or continued rapid debt retirement. Largely because of the expectation of continued foreign debt payments, tax reduction won the day on both occasions. Still, revenue receipts outran expectations, and the surpluses continued through the decade. In all, over \$3,000,000,000 of the federal debt was retired from this source. By 1930, the federal debt was under \$16,000,000,000.

Debt conversion, 1919-1930

With the elimination of \$1,400,000,000 of short-term debt between August 1919 and July 1920 the Treasury's debt problem was somewhat eased, although not solved. The \$17,000,000,000 of long-term callable bonds were no worry, for their maturity dates were well in the future. But nearly \$2,800,000,000 of short-term certificates were outstanding, and over \$4,000,000,000 of Victory Loan notes were due to mature in 1923. High interest rates made prospects for refunding unfavorable.

The fall in interest rates accompanying the collapse of 1920-1921 cleared the way for conversion operations. Under the still effective authorization of the amended Second Liberty Loan Act, the Treasury sold over \$4,000,000,000 of intermediate-term Treasury notes and over \$750,000,000 of Treasury bonds between June 1921 and June 1923. Combined with retirement operations, these issues enabled the Treasury to clear the Victory note issue, reduce outstanding short-term certificates by \$1,700,000,000, and War Savings issues by \$500,000,000, relieving considerable maturity pressure and effecting a substantial saving of interest.

There was a new development in debt policy in 1927 and 1928 when the Treasury undertook the refunding of the Second and Third Liberty Loans both to establish better maturity sequences for the near future and to reduce interest obligations. Retirement had already reduced the outstanding amount of these two loans from the original \$7,500,000,000 to only \$1,200,000,000. Holders of this

BILLIONS OF
DOLLARS

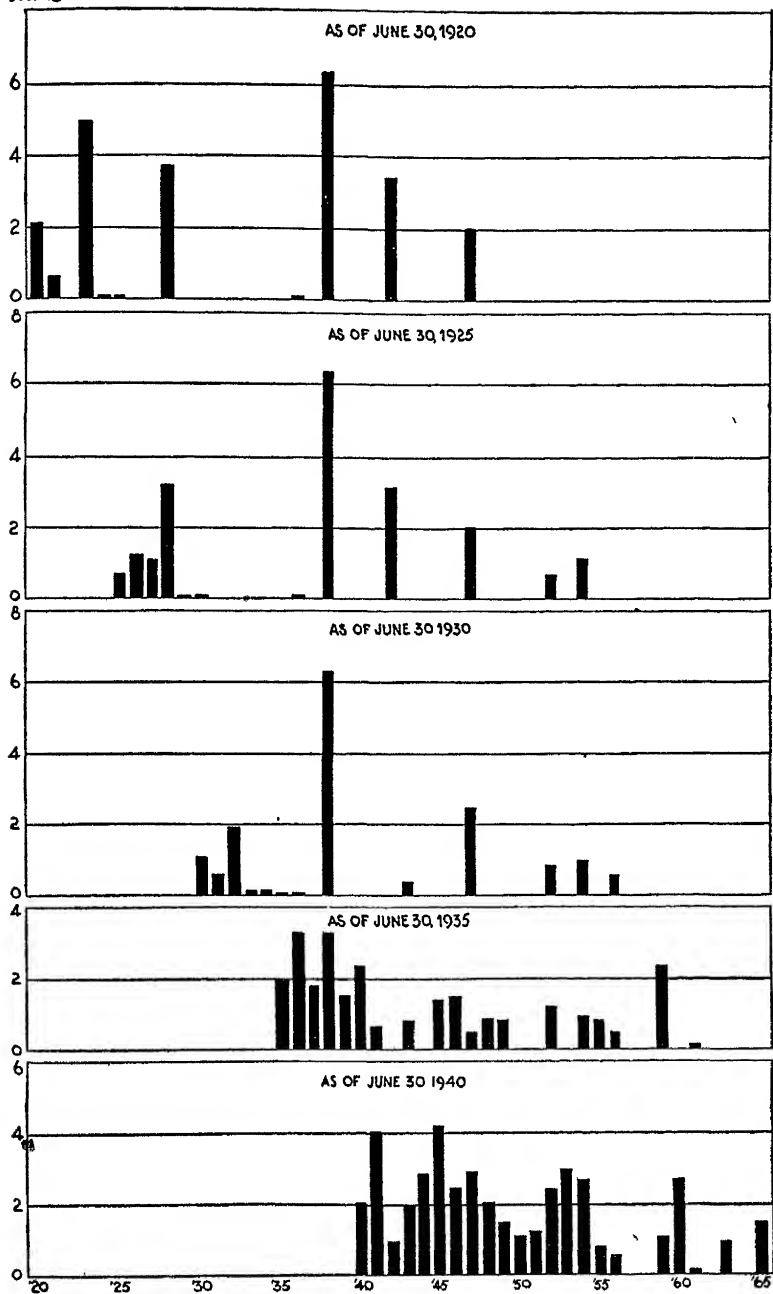


CHART XV. FEDERAL DEBT, DISTRIBUTION BY MATURITIES, 1920-1940

remaining amount exchanged their bonds for lower interest certificates, notes, and bonds.

Occasionally the objective of saving interest clashed with the objective of rearranging the federal debt with a view to maturity convenience. The particular category of debt—long-term, intermediate-term, or short-term—offering the greatest interest economy at the moment might be ill-adapted to maturity convenience. Many of the issues of the 1920's had to compromise between these opposing considerations. Sometimes, too, the Treasury had to consider the extraneous effects of its offerings on the money market. Savings securities, for example, were withdrawn after 1923 because bankers and other groups insisted that these issues were diverting deposit money from savings accounts and that their relatively high interest rate was forcing an artificially high market rate. Furthermore, the Treasury was inclined to maintain a large floating debt as a safeguard against Congressional proposals for extravagant expenditure, the "pressing problem" of short-term debt could always be cited in opposition to such proposals.

All things considered, retirement and conversion operations during the 1920's established the federal debt in excellent form. While only an inconsiderable fraction of the \$12,000,000,000 of long-term bonds would mature during the next few years, all but \$3,000,000,000 were callable within three years if further conversion opportunities should offer. The \$3,800,000,000 of intermediate and short-term debt could be retired at the Treasury's convenience if circumstances permitted, or funded if retirement was not in order. The average interest rate on the outstanding debt had been reduced from $4\frac{1}{4}$ per cent to $3\frac{3}{4}$ per cent—a saving of \$80,000,000 a year as of 1930. And never had federal credit been sounder.

Borrowing and conversion, 1931–1941

Depression brought increased federal expenditures, decreased revenues. Tremendous deficits replaced the substantial surpluses. From debt retirement, the Treasury switched abruptly in 1931 to large-scale borrowing. Between June 1930 and March 1933, \$4,700,000,000 was borrowed. By June 1941 the Roosevelt "recovery and relief" pro-

gram and the defense effort that began in the summer of 1940 had added another \$28,000,000,000 to the federal debt. The total of indebtedness that the federal Treasury was authorized to incur under the second Liberty Loan Act as amended had been \$49,000,000,000. This figure would have blocked borrowing for national defense in 1941, when the outstanding federal debt reached that figure. Accordingly, the Public Debt Act of 1941 raised the federal borrowing limit to \$65,000,000,000. In addition to the \$48,600,000,000 of direct federal debt outstanding in June 1941, contingent liabilities had been assumed by the guaranty of principal and interest payments on \$6,400,000,000 of bonds and notes issued by the Home Owners Loan Corporation, the Federal Farm Mortgage Corporation, the Reconstruction Finance Corporation, and other federal agencies.

These figures for gross liabilities take no account, of course, of offsetting assets. Over \$3,000,000,000 of the funds borrowed by the federal government was invested in the capital stock of various governmental corporations created during the 1930's. Furthermore, over \$6,000,000,000 of federal obligations was held by federal trust funds and agencies. And, finally, in recent years the Treasury has followed the practice of maintaining a substantial current cash balance; on June 30, 1941 it amounted to \$2,600,000,000. Thus, as against the \$48,600,000,000 of gross federal debt reported at the end of June 1941, the net debtor position of the government was \$37,100,000,000.

Fortunately for the Treasury, the market for federal securities was practically without limit. New private capital issues after 1931 were trifling in amount, grossly insufficient to supply private and institutional investment demand for safe placements. Commercial banks, unable to employ their resources in commercial or secured loans, also turned gladly to investment in federal issues. To ease credit conditions, the federal reserve banks purchased nearly \$2,000,000,000 of federal bonds on the open market between 1930 and 1934; their action made room on the market for a corresponding value of new issues. And, as indicated above, various federal trust funds absorbed over \$6,000,000,000 of special bond and note issues. Despite the enormous flow of federal issues, their interest rates were steadily lowered. In the late 1930's, bond issues were carrying $2\frac{1}{2}$

per cent, notes $1\frac{1}{4}$ per cent, and short-term bills a small fraction of a per cent.

Low interest rates enabled the Treasury to accomplish a most unusual transaction—while borrowing new funds, to convert over \$12,500,000,000 of its outstanding debt at a tremendous saving of interest. As will be remembered, \$1,400,000,000 of short-term certificates and

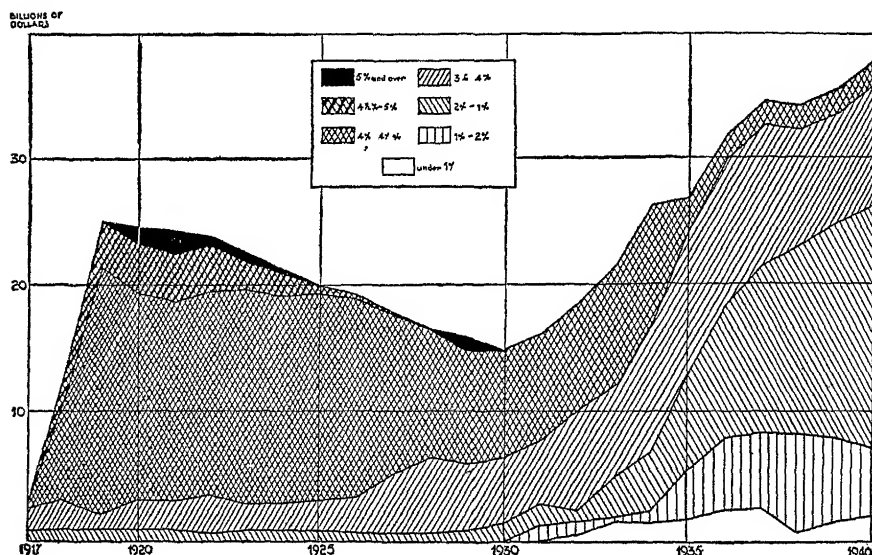


CHART XVI FEDERAL INTEREST-BEARING DEBT, BY INTEREST RATES,
1917-1940

bills were outstanding on June 30, 1930. As these matured, it was easy to replace them with lower-interest bills. Nor was it difficult to substitute lower-interest notes for the \$2,400,000,000 outstanding in 1930 when these became due in the course of the next few years. The Treasury's triumph came in 1933, 1934, and 1935 when \$1,900,000,000 of $3\frac{1}{2}$ per cent First Liberty Loan bonds and \$6,300,000,000 of $4\frac{1}{4}$ per cent Fourth Liberty Loan bonds, none of them yet due, were called and replaced by bonds bearing $2\frac{3}{4}$ to $3\frac{1}{4}$ per cent, and notes bearing $1\frac{1}{2}$ to $2\frac{7}{8}$ per cent. As a consequence of these conversion operations, the average interest rate on the federal debt declined from 3.8 per cent in 1930 to 2.6 per cent in 1936.

In its borrowing operations from 1931 to 1936, the Treasury was always anticipating that it would recommence retirement within a

year or two. Consequently, it consistently kept the federal debt in a form suitable for subsequent retirement rather than for further borrowing. From \$2,000,000,000 to \$3,000,000,000 was always maintained in floating form—certificates of indebtedness and Treasury bills—capable of immediate retirement. A disproportionately large part, over \$11,000,000,000 as of 1936, was kept in Treasury notes, due to mature in one to five years. And bond maturities were so fixed that the bonds would mature in relatively even annual amounts during the 1940's and 1950's.

A new policy on maturities was inaugurated after the summer of 1936. The administration had committed itself to an indefinite pol-

TABLE 36
COMPOSITION OF THE FEDERAL DEBT, JUNE 30, 1941

| Debt Issue | Interest Rate Per Cent | Date of Ma- turity | Date Callable | Amount Out- standing (millions) |
|-----------------------------|------------------------------|--------------------------|------------------|--|
| Panama Canal loan | 3 | 1961 | . | \$ 49 |
| Conversion bonds | 3 | 1946-47 | . | 29 |
| Postal Savings bonds | 2½ | 1941-59 | current | 117 |
| Treasury bonds (30 issues) | 2½-4¼ | 1941-65 | 1941-60 | 30,215 |
| Savings bonds | 2 9 | 1949-51 | current | 4,314 |
| Trust fund bonds | 3-4½ | 1945-46 | . | 741 |
| Total long-term debt | | | | \$35,465 |
| Treasury notes | ¾-2 | 1941-45 | . | \$ 5,698 |
| Trust fund notes | 2-4 | 1942-46 | current | 3,329 |
| Total intermediate debt | | | | \$ 9,027 |
| Trust fund certificates | 2½-4 | current | .. | \$ 2,292 |
| Treasury bills | discount | current | .. | 1,603 |
| Total short-term debt | | | | \$ 3,895 |
| Total interest-bearing debt | | | | \$48,381 |
| Matured debt | | | | 205 |
| Non-interest-bearing debt | | | | 369 |
| Gross debt.. | | | | \$48,961 |

Derived from United States Secretary of the Treasury, *Daily Treasury Statement*, June 30, 1941

icy of deficit financing. Faced with the prospect of continued borrowing, the Treasury decided to clear itself of a major part of its intermediate- and short-term debt, so that it would not be harassed by constantly recurring maturities. Between 1936 and 1941, \$5,700,000,000 of notes were replaced by bonds. During the same period, the volume of short-term bills was lowered to \$1,600,000,000—a \$750,000,000 reduction. Although long-term bonds in a period of low market rates generally must carry a higher yield than shorter term issues, shrewd management by the Treasury that took full advantage of market opportunities and replaced high-interest issues with lower-interest issues enabled it to effect savings of interest, and the general average on the outstanding debt declined from 2.6 per cent in 1936 to 2.5 per cent in 1941.

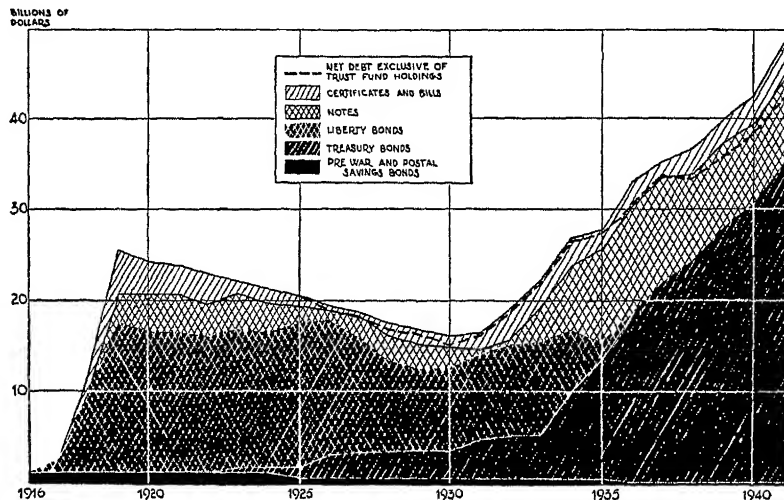


CHART XVII. FEDERAL INTEREST-BEARING DEBT, BY TYPE OF ISSUE, 1916-1941

Curiously enough, nominal debt retirement continued through the 1930's even while the government was incurring deficits and borrowing. Foreign debt payments were generally indefinitely suspended in 1931 when Germany discontinued her reparations payments, but nearly \$33,000,000 of token payments were received in 1933 and applied to debt retirement. Not only did sinking fund payments continue under the old arrangement, but the National In-

dustrial Recovery Act broadened the fund plan by voting an additional annual appropriation equal to $2\frac{1}{2}$ per cent of expenditures made under the "public works" title of that act. Since every dollar paid into the fund compelled the Treasury to borrow an additional dollar, such retirement was, of course, purely nominal. But the government thereby reaffirmed its intention of ultimate debt retirement.

Contingent federal debt

Prior to 1932 the federal government had had little occasion to guarantee the debt issues of other borrowing agencies. The entry of the federal government into the public enterprise field by means of quasi-independent corporations during the 1930's, described in Chapter VII,² created both the possibility and the necessity for such underwriting. HOLC bonds, for example, would have found no market at their stated interest rates if their only security had been the assets and operations of the HOLC itself. But with the guaranty of the federal government to back them, they were attractive investments for various types of financial institutions.

TABLE 37
CONTINGENT FEDERAL DEBT, 1941¹
(Amounts in millions)

| <i>Primary Obligor</i> | <i>Authorized Maximum</i> | <i>Out- standing</i> |
|--------------------------------------|-------------------------------|--------------------------|
| Commodity Credit Corporation | \$ 1,400 | \$ 696 |
| Federal Farm Mortgage Corporation . | 2,000 | 1,271 |
| Federal Housing Authority . . . | 4,000 | 17 |
| Home Owners Loan Corporation . . . | 4,750 | 2,421 |
| Reconstruction Finance Corporation . | 3,382 | 1,742 |
| United States Housing Authority . | 800 | 226 |
| Total. | \$16,332 | \$6,373 |

¹ Exclusive of obligations held directly by the Treasury.

As of June 1941, \$6,373,000,000 of such guaranteed securities were outstanding, as shown in Table 37. HOLC bonds accounted for over \$2,400,000,000 of this total, RFC notes not held by the Treasury for

² See pp. 179 ff of this volume

\$1,700,000,000 and Federal Housing Authority obligations for most of the remainder. These guaranteed issues are a contingent liability of the federal government. Most of them will unquestionably be liquidated without recourse to the federal guaranty. But in some cases this guaranty may have to be invoked—before the affairs of these agencies are finally wound up, the federal Treasury may have to honor its contingent obligation.

STATE AND LOCAL DEBT ³

The first public borrowing in America was done by the English colonial governments, the direct sovereign predecessors of the later state governments. In 1690 the Massachusetts government issued £7000 of one-year "bills of credit"—what we would call today "treasury bills"—to tide it over a deficit caused by expenditures for King William's War. Within a few years £40,000 of these Massachusetts bills of credit were outstanding, and circulating as currency. During the first half of the eighteenth century, continued emission of Massachusetts bills of credit with inadequate provision for redemption caused their depreciation to small fractions of their face value. Before 1750 nine other colonies had also issued bills of credit intended to circulate as currency, but they exercised more moderation than Massachusetts, and the discount on their issues was generally slighter. In 1751 the English government forbade the New England colonies to issue any more legal-tender bills of credit, except to cover current expenses and to finance war costs. For the next twelve years, New England bills of credit were issued purely as debt instruments in moderate amounts, were frequently backed by sinking funds, and were redeemed when due. The southern colonies, however, indulged in an orgy of bills of credit during the 1750's, and in 1764 England extended the prohibition of the 1751 act to all the colonies.

State borrowing, 1775–1790

The state governments established as a result of the Revolution were in general financially irresponsible. Even though the material

³ A superb recent study of state debt, covering both history and analysis, is Benjamin U. Ratchford, *American State Debts* (Duke University Press, Durham, 1941).

circumstances of their populations would have permitted taxation sufficient to cover both civil and war expenses, most states preferred to cover both expenditures by borrowing. A staggering total of bills of credit and treasury notes was issued between 1775 and 1783—Virginia, for example, issued bills and notes with face values of £45,000,000 and \$7,000,000. Creditors of the state governments, particularly officers and soldiers of the militia, were compelled to accept certificates of indebtedness as payment. Most, if not all, of the states sold “loan office certificates” to their citizens. Connecticut, Maryland, Pennsylvania, and Virginia endeavored to float loans in Holland, France, and Tuscany, and Virginia actually succeeded in obtaining a small foreign loan.

After the Revolution there was much discussion of debt redemption in the state assemblies, but only Connecticut, Maryland, North Carolina, and Virginia were willing to levy the necessary taxes. The other states continued to borrow or issue paper money for current expenses throughout the 1780's. With the ratification of the Constitution and the establishment of the federal government, the state governments apparently took a firmer financial grip on themselves, discontinued further borrowing, and cleared the debt that they had accumulated after the Revolution. Their Revolutionary debt, \$26,500,000 in all, was taken over by the federal government under Hamilton's debt assumption plan, and holders of state obligations were given federal bonds in exchange.

State debt during the nineteenth century

A few states negotiated bond or bank loans before and during the War of 1812. But large-scale state borrowing was not begun until the 1820's when several of the eastern states undertook to build canals. New York started the movement in 1817 by selling bonds to a New York syndicate to raise the first instalment of funds for constructing the Erie Canal. Pennsylvania and Ohio came into the market in the early 1820's, and the movement gained additional momentum in the 1830's. New York, Ohio, Virginia, Maryland, and other states floated bond issues to construct canals, turnpikes, and railroads. In addition, nearly all southern and western states bor-

rowed to buy stocks of the new banks being organized. During the three-year period 1835-1838, \$174,000,000 of state bonds were issued. In all, state borrowings during the 1820's and 1830's totaled \$193,000,000; some \$175,000,000 of "state improvement" debt was outstanding in 1841, a large proportion of the bonds being held by English investors.

The depression period which stretched from 1837 to 1843 cut heavily into state revenues. Debt service charges became even heavier. Agitation for federal assumption of state improvement debt arose, but nothing came of it. By 1840 the pressure of debt service charges had become too heavy for seven of the states, and they defaulted temporarily on their interest payments. Mississippi and the territory of Florida repudiated outright the principal of two bond issues floated to provide capital for banks which had failed.

State borrowing practically ceased between 1840 and 1845, both because a halt was called to improvement projects and because the previous defaults had weakened state credit. To assist railroad building, a number of western states borrowed considerable sums in the late 1840's and during the 1850's. By 1860, state debts outstanding totaled \$257,000,000. Scattered defaults by the states were common through these years.

During the Civil War both the Union and the Confederate state governments offered enlistment bonuses and raised and equipped regiments which they placed at the command of the central governments. With their civil expenditures already rising because of inflation, these added military costs could be covered only by borrowing. Investment capital was scarce in the South, wary in the North, but both groups of state governments succeeded in their borrowing efforts. Bond issues of the northern states totaled \$112,000,000. Southern state loans, in the form of bond issues, currency note issues, and voluntary or forced contributions from state banks, totaled \$96,000,000 at or near the close of the war.

For the next thirty-five years the northern states were more active in retiring outstanding debt than in new borrowing, and had \$100,000,000 less debt outstanding in 1902 than in 1870. The war indebtedness of the rebel states was flatly canceled by the Fourteenth

Amendment. But during the period of "carpetbag rule" which followed the Civil War, the southern states were unfortunately saddled with an outrageous debt load. Between 1865 and 1873, the South Carolina administration borrowed \$22,000,000, Alabama borrowed \$25,000,000, and Louisiana \$37,000,000. Over \$136,000,000 was added during this period to the \$111,000,000 of southern state debt outstanding in 1865. Service on this debt burden could not be carried by the economically exhausted region. In spite of bitter protests by northern and English investors, the Democratic administrations which replaced the carpetbaggers in the 1870's either repudiated or scaled down many of these bond issues. In all, \$115,000,000 of the "carpetbag" state debt was sloughed off. No new southern state borrowings were made during the rest of the century.

Local debt during the nineteenth century

We have only scattered items of information on the borrowing activities of local governments prior to the Civil War. There is evidence that Philadelphia borrowed \$150,000 for the construction of a water system in 1789. New York funded a \$900,000 accumulation of floating debt in 1812. By 1843, the seventeen leading cities had some \$25,500,000 of debt outstanding. During the late 1840's and early 1850's, cities and counties borrowed heavily to erect public buildings and to aid railroad construction. Default on these local obligations was common. Warned by these defaults of some of the dangers of unrestricted public borrowing, a number of states imposed constitutional restrictions on the borrowing powers of their local units.

Until 1850, each local loan generally required a special enabling act passed by the state legislature. From 1850 on, constitutional amendments or general municipal laws delegated broad independent borrowing powers to local units. Generally these were hedged with limitations, as noted above, but all too frequently there were either no limitations or overgenerous ones. Consequently, in the fifteen years following the Civil War, local governments were able to indulge themselves in extravagant and irresponsible borrowing. The classic illustration is New York's floating a loan to provide funds

for scrub pails and mops. Local debt increased from approximately \$200,000,000 in 1865 to nearly \$850,000,000 in 1880. Railroad aid, funding, and refunding issues accounted for nearly half the total. Defaults, many of them willful, were widespread during the depression period of the 1870's. This financial irresponsibility inspired another wave of restrictive legislation. Prohibitions against lending public credit to railroads and other private business enterprises were enacted in a number of states; by 1880 local governments in half the states were bound by this limitation. The debt-to-property ratio limitation on local government, first applied by New York and Iowa in the 1850's, was widely adopted during the 1870's.

As a consequence of the defaults of the 1870's, local units found it difficult to borrow during the 1880's. By the next decade, however, investors had apparently forgotten their earlier unhappy experiences, and again lent freely to cities for schools, street construction, and public buildings, and to rural units for road construction.

State and local debt, 1900-1932

Local borrowing, mainly for the construction of schools, highways, and city streets, continued at accelerating pace from 1900 until 1917. New local loans far exceeded retirements of old debt. Local debt outstanding had been \$1,630,000,000 in 1902; by 1912 it had more than doubled to \$3,477,000,000; by the time of America's entry into World War I, it is probable that another \$3,000,000,000 had been added to the figure. State debt doubled during this period as an increasing number of state governments undertook the responsibility of constructing arterial motor highways.

From 1917 through 1919 the federal government absorbed all investment funds through its Liberty and Victory Loans, and state and local borrowings were negligible. Beginning in 1919, state and local governments renewed their construction projects on a greater scale than before, and consequently borrowed more heavily than ever before. Despite an increasing volume of retirement, state and local debt increased after 1923 at the rate of \$1,400,000,000 a year—a large-scale application of “instalment plan” principles to government financing. State issues accounted for a relatively small

fraction of the state-local total of new borrowings during this period. Even the counties borrowed more than the state governments did. The most insistent borrowers were the cities; their issues averaged nearly \$850,000,000 a year from 1924 through 1931—over three-fifths of the state-local total. By 1930 nearly \$18,000,000,000 of state and local debt was outstanding; interest payments on these obligations exceeded \$800,000,000.

TABLE 38
LOCAL DEBT, 1912, 1922, AND 1932
(Amounts in millions)

| Borrowing Units | Gross Debt, 1932 | | | | Gross Debt Less Sinking Fund Assets | | |
|------------------|------------------|--------------------|-----------|----------|-------------------------------------|---------|----------|
| | Funded or Fixed | Special Assessment | All Other | Total | 1912 | 1922 | 1932 |
| Counties | \$ 2,143 | \$ 163 | \$ 225 | \$ 2,531 | \$ 371 | \$1,273 | \$ 2,391 |
| Municipalities | 8,285 | 935 | 768 | 9,989 | 2,872 | 4,679 | 8,842 |
| School districts | 1,993 | | 184 | 2,176 | 119 | 1,053 | 2,040 |
| Townships | 255 | 25 | 73 | 353 | 78 | 123 | 344 |
| Other | 1,130 | 388 | 113 | 1,631 | 36 | 626 | 1,599 |
| Total | \$13,806 | \$1,511 | \$1,363 | \$16,680 | \$3,476 | \$7,754 | \$15,216 |

Derived from U S Bureau of the Census, *Financial Statistics of State and Local Governments, 1932*, pp 12 and 50

Over three-fifths of state borrowings during the 1920's went into highway construction. Other purposes of state borrowing, in descending order of importance, were: public-service enterprises, veterans' bonuses, charities and corrections, schools, and public buildings. Half the tremendous city borrowings went to construct schools, streets, and water supply systems; the other half was scattered over a wide variety of purposes, such as construction of sewerage systems, parks and playgrounds, public buildings, charities and corrections, utility systems, and so forth. Counties and townships borrowed primarily for road and school construction.

The form of state and local borrowings during this period shifted to a large extent from the sinking-fund bond to the serial bond.

At first, the onset of depression in 1929 had little effect on state

and local borrowing. If anything, the market for municipals improved as investment funds were shifted from shares to bonds. By 1931, however, local governments were hesitant about undertaking new construction projects, and a general fall in bond values increased the difficulty of placing municipal issues. Although state governments increased the tempo of their borrowing, local borrowing slowed down; between 1931 and 1933, new local issues exceeded retirements by only \$100,000,000.

TABLE 39
STATE AND LOCAL BORROWINGS, BY GOVERNMENTAL
UNITS, 1924-1940

| Class of Govern- mental Unit | Average Annual Amount (in millions) | | | Percentage Distribution | | |
|---------------------------------|--|---------------|---------------|----------------------------|---------------|---------------|
| | 1924- 1931 | 1932- 1934 | 1935- 1940 | 1924- 1931 | 1932- 1934 | 1935- 1940 |
| States | \$ 185 1 | \$221 7 | \$ 219 0 | 13 1 | 28 8 | 20 0 |
| Counties | 233 5 | 98 4 | 126 5 | 16 6 | 12 8 | 11.6 |
| School districts | 144 2 | 37 0 | 95 9 | 10 2 | 4 8 | 8 8 |
| Cities and towns | 845 0 | 412 8 | 651 7 | 60 1 | 53 6 | 59 6 |
| Total | \$1,407 8 | \$769 9 | \$1,093 1 | 100 0 | 100 0 | 100 0 |

Derived from *Commercial & Financial Chronicle*, Municipal Supplements.

State and local debt, 1933-1940

Beginning in 1932, relief provision for the victims of depression imposed upon state and local governments new expenditure obligations which in many cases could be met only by borrowing. States, cities, and counties whose credit was still sound borrowed nearly \$200,000,000 for relief purposes in 1933, over \$200,000,000 in 1934; in all, state borrowings for relief between 1932 and 1938 totaled \$468,000,000.

Meanwhile, however, three states and over three thousand local units which had overborrowed in the preceding flush years or whose revenues were exceptionally cut by depression, were defaulting on their debt services. Practically every city whose debt

exceeded 15 per cent of its taxable wealth became involved in "debt trouble." Half the Florida municipalities were in difficulties. Investment capital shied away from the issues of all but the soundest governments. Most states could still borrow and did borrow for relief purposes, though on a diminishing scale after 1933. State debt outstanding increased from \$2,900,000,000 in 1932 to \$3,300,000,000 in 1938. Local borrowing was so reduced, however, that for several years after 1933 the few new issues floated were more than offset by the obligatory retirements taking place. The \$16,500,000,000 of local bonded debt outstanding in 1933 was a peak amount, at least for several years to come.

PART V

FEDERAL-STATE-LOCAL FISCAL INTERRELATION-
SHIPS

CHAPTER XXIX

State-Local Fiscal Relationships

DURING the nineteenth century, state and local functions were sharply differentiated. State governments, aside from their unfortunate ventures into canal building and railroad aid, engaged in few "service" functions, limiting themselves to the provision of judicial systems and the machinery of political government. Local governments provided the structure for local political government, and performed such service functions as the times demanded. Municipalities supplied police and fire protection, streets, garbage and rubbish disposal, education, and a few welfare services. Counties and towns were responsible for rural protection, road building and maintenance, and the care of the aged poor. School districts provided nonurban education.

State and local spheres of taxation, on the contrary, were not so clearly separated. Most state revenue was derived from supplementary property tax rates superimposed upon local rates. Local officials collected both the local and state levies, and the states received their shares of property tax revenue from the local units. The property tax produced another instance of state-local fiscal interrelation—usually, state tax bodies assessed the operative property of public service enterprises and reported these assessments to the local units. But the nineteenth century trend was towards the elimination of even these revenue interrelationships. New taxes—corporation taxes, inheritance taxes, and others—were levied and collected exclusively by the state governments, their revenue going entirely to the state governments. Some early American writers on Public Finance anticipated that eventually there might be as complete a separation of sources of revenue between state and local governments as there was of functions.

The twentieth century has seen the collapse of this state-local

fiscal compartmentalization. Many long-established local functions are now recognized as having extra-local aspects. Children educated in one community, for example, may at maturity scatter all over the state and carry the good or ill effects of this education far beyond the bounds of the locality that schooled them. Furthermore, all over the country local "service" functions have been expanded to a point where they overreach local administrative capacity and local revenue resources. Serious state-local fiscal problems have been created. Should state governments take over all or any part of various local functions which have developed extra-local character or have expanded beyond local revenue capacities? Should the states do anything about the inability of local property tax revenues to expand sufficiently to cover the expansion of local "service" expenditures?

During the past two decades considerable thought has been devoted to the issues of state-local fiscal relationships. The following canons have been evolved:

1. Governmental service functions should be performed by governmental units of the level best fitted to perform them. A function affecting only the residents or property of a locality, with no important secondary effects on other persons or property, is best administered locally; state administration could not have the flexibility to meet widely variant local peculiarities and problems. Local handling of police and fire protection is probably immensely more effective than state handling of these functions could possibly be. Where there is no localization of the causes or benefits of a function, state administration is obviously indicated; a state university to which residents of the entire state are admitted must be the responsibility of the state government, not of the municipality in which it chanced to be located. But some functions primarily caused by or of benefit to local persons or property have important secondary effects on other persons and property. Road construction and maintenance and various public health procedures are illustrations of such functions. If the local and extra-local elements of the function can be separated, local authorities may retain the local features of the function while state authorities take over the extra-

local. To a considerable extent, this has been the procedure in highway construction and maintenance. Where the two elements cannot be separated, the entire function may be left to the local authorities, subject to some degree of state control or supervision.

2. Taxes should be administered and collected by governmental units of the level best fitted to administer them. Except for the property tax and some minor business license taxes, this rule means state rather than local tax administration.¹ Personal income taxes, death taxes, and most business taxes cannot be levied successfully by local governments, because they could be avoided too easily by the migration of large taxpayers, and because the administrative problems raised by these taxes are beyond the capacities of local administrative machinery. Furthermore, variation in the rates and burdens of these taxes from county to county, or city to city, runs counter to the popular feeling that there should be a broad degree of territorial uniformity in these taxes.

3. Unfortunately, the most advantageous distribution of governmental service functions according to the canon of functional fitness does not coincide with the optimum distribution of tax administration. Local governments are best fitted to perform the larger proportion of the service functions. State governments are better fitted to levy, administer, and collect most of the taxes. Unless an equalizing factor is introduced, local governments are compelled either to restrict their functions below a socially desirable point or else to press to an unbearable extent upon the property tax and other revenues available to them. And so we come to the third canon of state-local fiscal interrelationship: The states must to an ever increasing extent devise means to put revenues they collect at the disposal of their local units.

STATE-LOCAL DISTRIBUTION OF FUNCTIONS

As noted in the beginning of this chapter, nearly all governmental "service" functions were begun by local governments. We have already indicated the exception of the early state canals. Agri-

¹ Reserved until the next chapter is the issue of the relative fitness of the federal government as against the state governments to administer certain taxes.

cultural assistance and forest preservation also developed initially as state functions. Unemployment insurance is another, more current exception. But these exceptions are so few in number, and so insignificant in relation to the tremendous volume of locally initiated "service" functions, that they serve merely to point the previous generalization. Incidentally, most of these local "service" functions at the time of their initiation conformed to the canon of functional fitness—they referred exclusively to local needs, or to what were believed to be exclusively local needs, and were best handled by local governments.

Shift of extra-local functions

General economic and social development has imposed extra-local significance upon many functions originally purely local in character. Roadways, for example, were essentially a medium of local transport during the nineteenth century. Intercity and interstate transport moved on rails or on water. Dirt roads sufficed for local horse-vehicle traffic, and local governments were well fitted to construct and maintain dirt roads. When the development of the automobile made interurban traffic common, arterial highways had to be built. These served needs far wider than those of the local districts through which they passed. Through no act or choice of the road-building units themselves, highway construction had expanded beyond their legitimate scope.

Some local functions had extra-local significance from their very inception, though recognition of this circumstance was slow in dawning. Today, all educators argue that education had extra-local overtones from its very beginnings. Even in the early and middle nineteenth century, persistent shifts of population carried the products of education out of the communities originally providing it. But this idea, and the derivative conclusion that state governments should share in educational responsibility, are fairly modern developments.

State governments have been very reluctant to take over, and local governments have been equally reluctant to surrender, functions which originated locally but developed extra-local character-

istics. Institutional inertia frequently stands in the way of application of the canon of functional fitness. Even where the local and extra-local elements are separable, the entire function is likely to be left to the local authorities, with some form of financial assistance and possibly some degree of control on the part of the state. Not until extra-local elements far outweigh the purely local elements, and local administration fails utterly, will state governments take over the function. Despite state control, the local construction and maintenance of arterial motor highways, for example, results in piecemeal and uncoordinated highway work, with awkward gaps in state highway systems, inadequate and varying standards of construction and maintenance, and excessive costs because of small-scale operations and lack of information about recent developments in highway technique and about the results of scientific road tests and investigations. Yet fifteen to twenty years after the inadequacy of the arrangement was widely recognized, motor highways continued to be the responsibility of local governments even in the most progressive states, with the latter providing varying degrees of financial assistance and control. And today a number of mid-western state governments still take no direct part in building or maintaining the state highway systems.

Despite institutional inertia, however, the state governments are gradually but consistently assuming the extra-local functions which they are better fitted than the local governments to administer. Most state governments, in addition to subsidizing local road activities, now build and maintain all arterial motor highways. The North Carolina state government in 1931, the Virginia state government in 1932, and more recently the Michigan state government went a long step further and took over responsibility for county "feeder" roads, not primarily because of the extra-local significance of these roads but because it was felt that the state highway departments could do a better and cheaper job than the local authorities. And where state assumption is not complete, various elements of state functional control may be introduced in connection with state financial support so that local control over the function becomes purely nominal.

Only in rare instances does a state government take over an entire local function because some extra-local element has developed or become recognized. Usually the state takes over the extra-local element, leaving other elements with the local governments—the function becomes “shared” between the state and the local governments. This sharing of the highway function has already been noted. It occurs as well in the field of public health, where care of the insane and of the victims of special diseases is made a state function, the number of patients per local unit being too small to permit of efficient large-scale care and treatment, while other public health elements are left to the local units. Similarly, certain specialized elements of public education are handled through state agencies, while public education generally remains a local responsibility. Still another example of this sharing of functions is the development of state police.

In shared functions, lines of demarcation between state elements and local elements are sometimes difficult to draw, or are drawn at the wrong points. Conflicts of authority and lack of comity between state and local police are not uncommon. Every motorist has learned to dread the changes in highway construction which occur where village authorities remain responsible for the stretches of state highways passing through village limits. But these imperfections of function-sharing are minor flaws, and do not invalidate the fundamentally sound arrangement.

Local revenue deficiency and functional shifting

Inability of local units generally, or of particular poor units, to finance various purely local functions has sometimes given rise to demands that the state government take over the functions. Compliance with such demands would, of course, contravene the canon of functional fitness, and fortunately attempts at such functional shifting have met with little success. Governmental principles have had institutional inertia as an ally in preventing the transfers. The solution here is to make additional revenues available to the pressed local governments, according to one of the arrangements discussed below.

SEPARATION OF REVENUE SOURCES

Tax scholars writing during the early 1900's thought the disparity between local revenue resources and local revenue needs could be met by so-called "separation of revenue sources." State governments should forego their property tax levies, and possibly also their liquor license taxes, and derive their revenue exclusively from special corporation, income, death, and other taxes which local governments could not administer. It was argued that the discontinuance of state property tax levies would automatically go far towards easing the heavy burden of combined state and local property taxes on land and other forms of taxable property. Furthermore, local governments pressed for additional revenue could increase their property tax levies without thereby making intolerable the already high property tax burden. If only the local governments levied property taxes, it was argued, they could cover all their revenue needs from this source, and still maintain levies and assessments at a reasonably low level.

As a supplementary argument, it was pointed out that the value of parcels of property derives largely from the activities of local governments. Reserving the property tax to the local governments would contribute to tax justice by limiting the taxation of property values to the governmental agencies which created them. Furthermore, separation would force the state governments to develop other sources of revenue, which would give a more rounded character to the combined state and local tax systems. Finally, it was pointed out that the cessation of property tax levies by the state governments would end need for state equalization, since if property in each county or district were subject only to the tax levied by that county or district, the variations in county or local ratios would not matter. Scrapping the machinery of state equalization would be a step in governmental economy. And since it had never worked effectively anyway, property taxation would be relieved of one of its elements of weakness.

At present thirteen state governments impose no state property tax levies, and several others in the past have experimented with

complete or partial separation. A primary difficulty encountered has been the inflexibility of the taxes assigned to the state governments. Minute adjustment of their property tax rates to state-wide assessments previously permitted the state governments to equate expenditure needs and tax revenues with some degree of exactitude. Corporation, income, and death tax rates do not lend themselves to such adjustment and fractioning, and in addition, the yield of these taxes is highly variable. Corporation taxes and income taxes produce high yields in years of prosperity and low yields in periods of depression, while the yield of death taxes can never be predicted, since the demise of a single wealthy individual will upset all revenue calculations. Several state governments which relinquished property tax levies had to restore them subsequently as adjustable makeweights in their tax systems.

Moreover, it soon developed that the needs of many local communities quite outran the possibilities of their general property tax levies, even when the abolition of state levies permitted local units to rest on the property tax more heavily than before. State property tax levies, it was eventually realized, had never actually been very heavy, and at the most had been but a minor fraction of the combined state and local property tax levy, so that the absence of state levies did not give the local governments much additional leeway.

Finally, most of the state governments lost their interest in property tax administration when they relinquished their property tax levies. With all state restraint and supervision removed, the quality of local property tax assessment and administration deteriorated. Inequalities between assessments of individual parcels of property increased, and other assessment injustices were augmented. After having ended the necessity of equalizing property tax assessments for the purpose of state tax levies, the state governments found that they had to continue making equalizations of some sort to provide a basis for distributing local shares of state-collected taxes and some forms of state aid.

The advantages once thought inherent in state-local separation of new revenue sources have proved largely illusory. Serious prac-

tical disadvantages have been discovered to attach to the procedure. Separation no longer appears the fiscal panacea it was once hailed

SHARED TAXES ²

A second solution to the problem of unbalance between local revenue needs and local revenue sources is for the state governments to redistribute to their local units part of the revenue from state-administered and state-collected taxes. Such tax-sharing began even before 1900. Early state corporation franchise or privilege tax levies were usually accompanied by the release of corporate securities from general property taxation. To compensate local

TABLE 40
STATE-LOCAL SHARED TAXES, 1902-1940
(Amounts in millions)

| Tax | 1902 | 1912 | 1925 | 1928 | 1932 | 1934 | 1936 | 1938 | 1940 |
|-----------------------------|--------|--------|---------|---------|---------|---------|---------|----------------------|----------------------|
| Personal income | | \$ 1 2 | \$ 59 8 | \$ 57 5 | \$ 32 7 | \$ 28 9 | \$ 40 1 | | \$ 37 6 ^b |
| Corporation | \$ 6 4 | 13 3 | 37 4 | 62 0 | 33 9 | 24 7 | 44 7 | \$ 66 7 ^a | 45 4 ^b |
| Death | 2 | 5 | 3 4 | 4 6 | 3 1 | 2 6 | 3 4 | 4 | 3 2 |
| Motor vehicle | | 9 | 58 2 | 67 0 | 52 6 | 61 9 | 74 3 | 59 9 | 80 2 |
| Motor fuel | | | 28 8 | 64 2 | 113 4 | 110 7 | 128 9 | 195 4 | 179 8 |
| General sales | | | | | | 3 6 | 79 0 | 36 2 | 30 4 |
| Liquor | 10 9 | 14 2 | | | | 26 4 | 37 3 | 49 5 | 52 7 |
| Other | | 2 2 | 7 5 | 11 8 | 4 2 | 5 0 | 22 5 | 59 8 | 43 9 |
| Total | \$17 5 | \$32 3 | \$195 2 | \$267 2 | \$239 9 | \$263 7 | \$430 1 | \$467 8 | \$484 6 |
| Proportion of local revenue | 2 3% | 2 2% | 4 7% | 5 4% | 4 6% | 4 3% | 4 1% | 3 2% | 3 4% |

a. Includes personal and corporation income taxes, other corporation taxes included under "other"
b. Plus \$11 4 million from income taxes not separable into personal and corporation

Derived from Twentieth Century Fund, *Facing the Tax Problem*, pp 577-578, United States Bureau of the Census, *Financial Statistics of States, 1938*, and *State Tax Collections, 1940*.

units for whatever loss of revenue was thus incurred, a dozen or more states before 1900 gave counties or other local units some share of the corporation tax collections. One state shared its inheritance tax receipts. New York and a few other states redis-

² The federal Bureau of the Census counts a tax as "shared" only when it is redistributed back to the localities substantially in proportion to collections. Most fiscal economists take the view that any distribution of a prescribed fraction of a tax back to the localities on any basis makes it a "shared" tax. The discussion that follows is based on the second interpretation of tax "sharing." The figures for 1938 and 1940 in Table 40 have been adapted to this second interpretation.

tributed part of their state liquor tax collections back to their local governments.

After 1910, the principle of state-local tax sharing spread rapidly. The impetus came from abolition of various elements of intangible property taxation, with the substitution of state-collected *in lieu* taxes.³ These reforms of the general property tax tended to deprive the local governments of part of their property tax base, and elementary justice dictated that they be allowed to share in the special substituted taxes levied by the state governments. Local governments thus were granted a share in the proceeds of state-administered mortgage taxes, motor vehicle license charges, bank share taxes, severance taxes, and personal and corporation income taxes.

During the 1920's, tax-sharing was increasingly motivated by the recognition that local property tax revenues were insufficient to cover local expenditures adequately. In many instances, probably, the circumstance that local functions involved extra-local elements was an influencing factor. This functional tie-up is indicated by the frequency with which the tax shares granted during these years were earmarked to particular functions; shares in motor vehicle and gasoline tax revenues were earmarked to roadway construction and maintenance, shares in income and corporation tax revenues were earmarked to educational expenditure.

Recent tax-sharing legislation has turned away from the earmarking principle. The drop in local property-tax collections as a consequence both of depression and of the passage of new tax-limitation laws in some states has made property tax revenues in many localities inadequate to cover even purely local functional expenditures. To have earmarked the shares of sales tax, income tax, business tax, and other tax revenues given to these hard-pressed units would not have solved their problem. Their need was not for more street funds or school funds, but for sufficient revenue to enable them to survive. And so, once again, local governments have been given "general fund" shared revenues.

At present forty-one states share one or more taxes with their

³ See p 365 of this volume.

local units. From a revenue standpoint, the gasoline tax is the most important shared tax. Thirty-one states gave their local units \$180,000,000 from their gasoline tax receipts in 1940; this was over one-fifth of the total state gasoline tax collections for the country. Sixteen states allowed their localities a share in their motor vehicle license revenues; in two cases, practically the entire amount collected was distributed to the local units. Sixteen states distributed part of their liquor sales or liquor license taxes. Six of the thirty-two states imposing corporation income taxes and ten of the thirty-four states imposing personal income taxes shared these with their local governments. Among other taxes shared in some states are sales taxes, inheritance taxes, severance taxes, and mortgage recording taxes.

Bases of distribution

With what class or classes of local units—counties, townships, cities, villages, school districts, special districts—shall a state share its revenues? All are afflicted with a fundamental insufficiency of tax base in view of the functions they are called upon to exercise. All have claims upon the state for fiscal assistance. On paper it might be possible to work out a system of distributing shared taxes that would do justice to the claims of all classes of a state's local governments. What actually happens is that one tax is shared with the counties because relief of the farm tax burden was forcibly urged upon a legislature, or because champions of highway construction or charitable work—functions exercised primarily by the county governments—pleaded for more county revenue for these functions; another tax with a different unrelated yield is shared with the cities because their mayors made an effective lobby; still another tax is shared with the school districts as an alternative to state school aid. Such haphazard grants of tax shares are inefficient and produce almost as much inequity as relief. As one recent study of the subject concludes:

Where the structure of local government with a state varies in different areas, it is practically impossible to share taxes with a

given type of local government, without providing some units with needless revenues, and giving little relief to others. To an extent the apportionment to one class of authority relieves pressure on the revenue sources of the others, but the independence of action of each body and the restriction of their tax powers tend to reduce this advantage.⁴

The simplest method of distributing shared revenue to a class of local government is to return to each locality a prescribed fraction of the tax actually collected there. Motor vehicle license tax, sales tax, and liquor tax collections are usually shared on a "source" basis. Such distribution is the exception with gasoline taxes, death taxes, and corporation taxes. "Source" distribution of shared income, death, and corporation taxes is open to obvious criticism. A community "colonized" by wealthy individuals might receive more shared income and death tax revenue than it could properly use, while poor communities, where the need for shared revenue is much greater, would receive but trifling assistance. "Source" distribution of corporation taxes is still less justifiable. Large corporations having widely scattered operating properties pay state taxes through their head offices, and these are likely to be grouped together in one or two leading cities in the state. "Source" distribution of the taxes would give these cities, or their counties, a royal revenue while all other communities would receive mere dribbles. Sharing gasoline, motor vehicle, and sales taxes on a "source" basis results in a more even distribution of the revenue. Relative needs of the sharing communities are still ignored, but at least there are no glaring inequalities.

A second method of distribution has been devised for shared income, corporation, and other taxes, which eliminates the inequalities arising from direct "source" distribution. Shared revenues are apportioned on some *presumptive* basis of collection, such as population or the value of properties assessed for general property taxation. When assessed valuations are the standard, it is desirable, from one point of view, to use the figures for equalized valuations

⁴ Henry J. Bittermann, *State and Federal Grants-in-Aid* (Mentzer, Bush & Co., New York, 1938), pp. 44-45.

rather than those for original assessments, so that the differing ratios of assessment in the various parts of the state do not affect the distribution of the shared revenue. However, some tax administrators champion the use of original assessments as a distribution basis, on the theory that it will induce local assessors to increase the ratio of property assessment, and make extra efforts to discover unlisted property, in order to secure as large a share of the distributed revenue as possible for their own districts. It is argued that the advantages of a vigorous incentive to good assessment outweigh the injustices involved in possible disproportionate distribution of the shared revenues.

Still another basis for distribution, frequently employed where the shared revenue is earmarked to some particular function, is some measure of the relative obligations of the localities in connection with that function. Several states, for example, distribute part of their shared gasoline tax revenues on the basis of highway mileage. Special property, income, and other tax revenues earmarked to school expenditure, or distributed among school districts, may be apportioned according to school census figures or school attendance. Such sharing systems are a step towards the desirable goal of equalization—but only a step, since they do not take into account the varying capacities of the localities to support the functions to which the revenues are earmarked. And if equalized support of some local function, particularly one with extra-local elements, is desired, a grant-in-aid which entails an element of state control would seem a more efficient method than an equalized sharing of some tax revenue. This criticism would not apply to an equalized tax-sharing if the shared revenue went into the general funds of the benefited local governments—but until now equalizing bases of distribution have not been applied to general-fund revenue-sharing.

Critique

Shared taxes are a useful means of relieving local revenue stringencies. State legislatures have been generous in their grants, but so far, they have given the technique of distribution indifferent

or casual attention, with the result that in many states serious defects mar the sharing system. Most of these can be corrected, and probably will be corrected in time as the legislatures become aware of the abuses involved. One disadvantage of tax-sharing, however, is inherent in the system itself and cannot be modified. Local governments are compelled to depend for part of their revenues upon an outside source unrelated to their individual peculiar necessities. What is more, the local shares of certain taxes—personal and corporation income taxes for example—vary widely through successive phases of the business cycle, with unfortunate consequences for local budgets.

SUPPLEMENTARY LOCAL RATES

Some writers have suggested, as an improvement upon tax sharing, an arrangement whereby local governments could superimpose supplementary rates upon various state taxes collected within their jurisdictions. Cities and counties would be authorized to add an extra per cent or two to the state income taxes imposed on their inhabitants, or perhaps an extra cent on gasoline sold within their territory, or perhaps an extra half per cent on local sales. State agencies would remain fully responsible for administering the tax, would collect both the state tax and the supplementary local levy, and would remit the supplement to the locality.

This system, it is claimed, opens to localities the possibility of revenue from a wide range of taxes other than the property tax without subjecting them to an arbitrary financial arrangement imposed by an outside authority—the state legislature. Each locality can set its supplementary rates at the levels dictated by its particular needs, and can vary them as circumstances change.

But supplementary local rates present more disadvantageous than advantageous features. Essentially, they are voluntary instead of universal sharing on a "source" basis, and are subject to all the weaknesses of "source" sharing. If used in connection with personal income, death, or corporation taxes, only a few fortunately situated communities could derive any substantial revenue from them. And rarely if ever could a supplementary rate equal the

History

American state-local grants-in-aid can be traced back to the seventeenth century, when several of the colonial governments set aside various land grants for the support of the public schools. In 1795 Connecticut set up a Permanent School Fund, the income from which was to be used in aid of local education. This aid, distributed to the school districts in unconditioned grants, caused them to depend almost exclusively on state funds rather than attempt to raise revenue on their own accounts.

During the nineteenth century, a number of state constitutions recognized various degrees of state responsibility for education and provided for state grants when, as, and if funds became available. In a few instances the funds were appropriated and distributed. Nearly every state established a permanent school fund whose capital would be derived from the sale of lands granted by the federal government and by the states themselves for school assistance. The interest from these funds, it was thought, would cover a substantial fraction of school costs in perpetuity. But the management of most of these school land funds was scandalous, and today only three or four of the funds make any significant contribution to school support. In a number of states, the income of school land funds was supplemented by earmarked state taxes; early inheritance taxes were also frequently earmarked to state school funds. Such as they were, these funds provided small annual incomes to be distributed among local school districts. The amounts being small, they were usually distributed in some proportion to the relative school expenditures of the local districts, with a vague idea that the local districts would be encouraged to increase their school expenditures by the prospect of obtaining a larger share of state funds.

A final stage in state school aid history has been state legislative appropriation of regular and growing amounts for distribution among the local school districts either to encourage their education activities or, more significantly, to equalize relative educational opportunities between rich and poor districts. Massachusetts, in 1874,

was the first state to employ an equalizing basis in its distribution of school aid. With this development in school aid entered the factor of state governments using the grant-in-aid system to buy varying degrees of control over local educational administration

State highway aid developed considerably later than state school aid. Recognizing that local governments should not be called upon to bear all the expense of constructing and maintaining arterial highways, New Jersey in 1891 provided a small highway aid appropriation. Massachusetts did likewise in 1892, Connecticut and California in 1895. Within a short time, nearly all states had high-

TABLE 41
STATE-LOCAL GRANTS-IN-AID, 1902-1938
(Amounts in millions)

| Purpose | 1902 | 1912 | 1925 | 1928 | 1932 | 1935 | 1938 |
|-----------------------------|--------------|--------------|---------|---------|---------|---------|-----------|
| Education | \$45 4 | \$82.1 | \$254 1 | \$323 1 | \$397 4 | \$521 8 | \$ 642 5 |
| Highways | | ¹ | 63 1 | 42 1 | 63 0 | 57 5 | 75 5 |
| Welfare | ¹ | ¹ | 3 9 | 10 3 | 42 1 | 178 7 | 347 4 |
| Other | 12 9 | 4.5 | 19 5 | 6 9 | 16 2 | 15.1 | 4 6 |
| Total | \$58 3 | \$86 6 | \$340 6 | \$382.4 | \$518 7 | \$773 1 | \$1,070 0 |
| Proportion of local revenue | 7 5% | 6 0% | 8 2% | 7 7% | 9 9% | 12 0% | 7 5% |

¹ Included with "Other"

Derived from Twentieth Century Fund, *Facing the Tax Problem*, pp 577, 579, and United States Bureau of the Census, *Financial Statistics of States, 1938*, p 97

way aid systems. Dominant from the very beginning was state desire to buy some control over local highway functions, in order to impose uniform standards of construction and maintenance. Not until the 1920's did many states introduce an element of equalization into their highway aid, to make possible the development of adequate systems of rural roadways in poor and sparsely settled sections.

State grants-in-aid are a relatively recent development in the welfare field. As late as 1925 only \$4,000,000 was distributed for such purpose. In 1932 the distribution was only \$42,000,000. Depression not only augmented the scope and volume of local welfare

functions, but introduced many extra-local elements, and the state governments had to come to the assistance of their hard-pressed localities. Between 1932 and 1935 welfare grants-in-aid more than quadrupled. The federal Social Security Act of 1935 laid a foundation for further enlargement of local welfare functions to be accomplished with increased state assistance. State-local grants-in-aid for poor relief, mothers' pensions, child aid, care of the blind, and other welfare purposes increased tremendously; by 1938, state-local grants-in-aid for these purposes were nearly \$350,000,000—almost double the figure for 1935. All indications point to the continued rapid increase of this class of aid.

State control

When state governments distribute school, road, welfare, or other aid to local governments, they usually provide that the local activity for which the aid is granted must measure up to certain state-prescribed standards. If a school or a piece of local highway construction fails to conform with the state standard, the local government cannot share in the state distribution. Partisans of local self-government have been bitter against this feature of state-local grants-in-aid, claiming that the state governments are in effect buying out the independence of local communities. This charge cannot be denied. But it may be fairly questioned whether buying out the "anarchy of local autonomy" in functions such as public education and highway construction which involve extra-local elements is not a pure benefit with few offsetting disadvantages. Were the local governments left to themselves, their indifference, ignorance, and inertia might result in reprehensibly low levels of educational and roadway accomplishment. State control, accepted because of the opportunity to share in state funds, guarantees at least a minimum level of achievement. And individual communities, fortunately situated as to resources and willing to employ those resources to public purpose, are in no way prevented from expending as much more than the required minimum as they wish.

There is, however, a latent danger in achieving state control of local functions through state aid if no element of equalization

enters into the distribution of the aid. The minimum standard of accomplishment required for participation in state funds may be set so high as to injure the poorer local districts. Counties, municipalities, and school districts within a state differ widely in their fiscal capacity. A state-standard school program putting no burden upon a rich suburban community might strain to the breaking point the resources of a poor rural district. Poor districts which do not meet this standard are excluded from any share in the state fund to which their taxpayers have contributed, and which they need much more than their more prosperous neighbors. Yet if the standard of accomplishment is set low enough to be within reach of the poorest communities in a state, it is likely to be so low as to be practically meaningless. Equalization aid, of course, does not create this problem.

Bases of distribution

Bases for the distribution of state aid to local governments differ according to the purpose to be effected by such aid.

Where a state government is interested only in supplementing local expenditures for particular functions, it can distribute fixed or proportionate amounts of state funds to local districts irrespective of their relative needs or accomplishments. School or road aid distributed on the basis of population or area would ease the local burden of financing these functions, but it would not necessarily improve the character of the education given or of the roads built. The distribution of school aid on the basis of school enrollment, and of funds for highway maintenance on the basis of existing highway mileage, might be fairer methods of distributing state aid, but they would be equally bare of extraneous accomplishment. Supplementary state aid distribution had historical precedence over other bases, but apart from relieving local property tax burdens, it has little, if anything, to recommend it.

Where the fund at the disposal of the state is relatively small, it is best distributed so as to encourage local activity, whether in road construction and maintenance or in education. A small state school fund might be distributed pro rata to school enrollment

with the proviso that the school curriculum or construction in each district receiving state money must first be approved by the state school authorities. State school aid might also be distributed to encourage local school activity by relating it to average teachers' salaries in each district, or to school costs per pupil in each district, thereby encouraging the employment of higher-salaried teachers or an increase in school expenditures. A small state road fund might be distributed pro rata to local highway expenditure or mileage of motor highways maintained by the local units. Distributed on such bases, small amounts of state aid may inspire local activities much greater than could be financed by the direct expenditure of the state fund. The danger of such methods of distribution is that the more prosperous districts, which can make large expenditures on the aided functions without straining their resources, will obtain a disproportionate share of the state fund.

Where a state government has a large aid fund at its disposal, part if not all of this fund should be used to equalize between richer and poorer districts, supplementing the deficiencies of the latter. State money enables the poor districts to provide vitally necessary school, road, welfare, and other governmental functions which, because of their poverty, they might not otherwise be able to finance. Strong state control over the subsidized local functions can still be maintained by requiring the subsidized local activity to conform with state specifications and standards before the governments undertaking it can receive any state money.

A thoroughgoing equalization grant would have to combine several separate elements in its distribution basis. First, the relative needs of the localities in connection with the function would have to be taken into consideration. In the case of school aid, this would involve the number of children of school age in each district, with some modifier to cover school attendance customs in the community. In the case of highway aid the factors would be area, population, character of traffic to be served, and also costs of construction as determined by topographical features and roadway character. For each class of welfare aid a suitable set of need determinants would have to be formulated.

A second factor which must enter into an equalization basis of state aid distribution is the relative ability of the various localities to support the function in question out of their own fiscal resources. Since the property tax is practically the sole source of most local revenue, this means relating the basis of distribution inversely either to property assessments or to the revenue which can be raised in the various districts by some prescribed property tax levy. Assessed valuations reported for property tax purposes are, of course, a very poor indication of the relative ability of local districts to support particular governmental activities. But since no state possesses accurate statistics on the income or wealth of the residents of its local subdivisions, property tax data are the best measure available. Attempts on the part of some states recently to use estimates of local wealth and income, or figures on local retail sales, in their aid distribution bases have produced injustices quite as serious as those which occur when property valuations are used.

During the years when equalization distribution was still in an experimental stage, some states made the mistake of distributing funds inversely to original property tax assessments, before these had been equalized by a state tax commission or a state board of equalization. It was soon evident that it was to the interest of each local district to assess its property as low as possible in order to obtain a larger share of state aid. Although this defect has been remedied in most states which provide for state equalization of property tax assessments, it remains a problem in states like Pennsylvania where abolition of the state property tax has eliminated state equalization of property assessments for state levy purposes.

Quite clearly, the current trend is leading away from supplementary and encouragement bases of state aid distribution to equalization distribution. Constitutional provisions requiring state school funds to be distributed on the basis of school population have, however, barred some states from devoting their state school funds outright to equalization. In other cases, small state school and highway funds have gradually evolved into large funds. Without any clear understanding of the difference between using a state fund to encourage local effort and using it to equalize local effort,

state governments have attempted to graft elements of equalization piecemeal into a distributive system built originally around a small state fund effective only for encouraging local effort. The result has been wasteful complexity. A special inquiry some years back into New York's method of distributing its state school fund led to the conclusion:

At present no less than thirteen different criteria are utilized in distributing state aid for schools. The system is so complicated that even those who are charged with the details of its administration testify that it is in some cases impossible to carry out the provisions of the law or even completely to understand them. . . . With all its complications, the system accomplishes almost nothing at all in achieving the end which is believed to be the primary purpose of a system of state aid, that is, the equalization of educational opportunity in providing an acceptable educational offering. In its attempt to accomplish many things it fails entirely to accomplish its main task of equalizing the support of education throughout the state. Indeed in some cases it appears to take from the poor and give to the rich communities.⁶

Fortunately, legislators are giving more thought to this problem now than formerly, and many of these incongruities are being cleared up.

State aid and governmental efficiency

In general, by holding some local governments to standards of functional performance higher than they would achieve on their own account, and by establishing elements of uniformity in extra-local functions, state aid combined with state control improves the quality of local governmental activity. Under certain circumstances, however, it may become a factor in perpetuating certain elements of inefficiency.

Scattered over the country are many "submarginal" school districts, road districts, villages, and counties, too small in geographic area or population, or too poor in taxable resources, to be able to

⁶ New York Legislative Document (1925) No. 97, pp. 27, 28

undertake the special functions which are the basis of their existence. Were no equalizing state aid available, their provision of schools, or roads, or poor relief, or other functions would be so shockingly inadequate that, once called to legislative attention, a fundamental solution of the problem would be sought. In many cases the difficulty might be met by consolidating or reorganizing the submarginal districts into better-balanced units. In extreme cases it might be advisable to move population groups from areas which cannot provide normal livings and resettle them elsewhere, in the process junking the governmental organizations of the submarginal areas. But a liberal state aid policy may enable governments in these submarginal areas to drag along a parasitic existence, and defer the reorganization or scrapping process which ultimately must take place. Surveys in New York during the 1930's, for example, disclosed school districts serving one or two children, when transportation to a nearby school would cost less and provide the children with better education; but nine-tenths or more of the school costs in these districts were covered by equalizing state aid, and so they were maintained. Even more striking examples were the towns whose highway payrolls, financed primarily by state aid, contained the name of every able-bodied man in the town, when the roads thereby maintained, together with the occasional submarginal farms they served, might better have been abandoned.⁷

Another occasional unfortunate consequence of state aid is its perpetuation of local administration of functions whose extra-local significance dwarfs their purely local elements, and which should be transferred to state administration. Local officials are more likely to cling to the power and influence which the administration of the function gives them, when because of state aid it involves little direct cost to their constituents. State highway aid has blocked the transfer of the highway function from the localities to the state governments in so many states, that some writers feel it has been more of a deterrent than an encouragement to the development of sound integrated motor highway systems.

⁷ See Mabel Newcomer, "Locally Shared State Revenues," *National Municipal Review*, Vol. XXIV, 1935, p. 680

CHAPTER XXX

Interstate and Federal-State Fiscal Relationships

RARELY, during the nineteenth century, did the fiscal activities of one state impinge upon those of another. Their functions could not possibly overlap. And, with most states depending for their revenues primarily on property tax levies, there was little chance of tax competition among them or of double taxation problems. The federal government and the state governments were also dissociated functionally and fiscally. Functions and revenue sources were both rigidly separated.

Interstate and federal-state fiscal compartmentalization, like state-local fiscal compartmentalization, are now things of the past. Tax bases overlap as between states, producing double taxation. States enter into tax competition, bidding for personal and business residents by the lure of low taxes. The federal government interests itself in functions formerly exclusive state or local prerogatives. And the states and the federal government encroach upon each other's tax realms, to the distress of taxpayers caught between the superimposed systems.

The fiscal issues involved in these interrelationships have become focal points of popular attention. We have become aware, at last, that problems—big problems—are presented by these interstate and federal-state fiscal interrelationships. As for solutions, we are at the stage of discussion and experimentation.

INTERSTATE FISCAL RELATIONSHIPS

State territorial separateness results in general dissociation of their service activities. New York's school and poor relief systems are no concern of New Jersey, and vice versa. Interstate functional cooperation occurs in highway and bridge construction, in police

work, and in some other fields, but such cooperation does not extend to fiscal provision for these activities. Where fiscal as well as functional unity is necessary to some interstate enterprise, the state governments are inclined to step out of the picture entirely, transferring the function and its fiscal provision to an independent service agency created by interstate compact. New York and New Jersey established such an agency, the Port of New York Authority, to develop the traffic facilities of the New York and Jersey City port areas; similar "authorities" have been discussed as possible solutions for other interstate service problems.

But the insularity of state functional activities is not duplicated in the revenue field. The legal fictions underlying taxation are not mutually exclusive along state lines, so that a single economic element may be subject to taxation on different bases by more than one state. "Compliance costs" of business enterprises having interests in more than one state are increased by the lack of uniformity in state tax systems. And personal and business mobility is sufficient to establish the states as competitors, on the basis of relative tax burdens, for the residence of certain classes of persons and business enterprises.

Double taxation

Three forms of so-called multiple or double taxation appear in the United States:

(1) Multiple-aspect taxation by a single taxing jurisdiction, as when a state subjects corporations to a capital stock organization charge, a net income annual franchise tax, a property tax on their property holdings, a sales tax on their sales, and perhaps still other special license taxes

(2) Superimposed taxation by taxing jurisdictions of different grades, as when the federal and state governments both tax personal or corporation income, or when a state government and various grades of local governments superimpose property tax rates on taxable property

(3) Overlapping taxation, as when two states, or two coequal local districts, impose similar taxes on occasional taxable objects because judicial construction of their tax powers allows of over-

lapping jurisdiction. Such overlapping taxation was formerly a major problem in state inheritance and business taxation, is still an issue in state personal income taxation.

No discrimination between individuals is involved in multiple-aspect taxation—or at least no more than may be involved in each individual tax in the multiple series. In the light of its effect on the distribution of tax burdens among individuals, therefore, it is unobjectionable—it is not “unjust” by any line of argument.

Superimposed taxation, likewise, works no discrimination between individuals, and consequently perpetrates no “injustice.” It may, however, profoundly affect the economic character of a tax. A federal income tax by itself may be heavy without being confiscatory. So too, a state income tax may impose a fairly moderate burden. But superimpose the two, and the result may closely approach confiscation.

Overlapping taxation by two states does discriminate between individuals. *A*, who lives in Mississippi and earns his \$25,000 income there pays an income tax of \$1165. *B*, who also lives in Mississippi but receives \$25,000 for services performed in New Orleans, pays \$1165 to Mississippi and \$800 to Louisiana. Although no one could possibly argue that *B*’s governmental benefits are more numerous than *A*’s, or that his taxpaying ability is greater, or that he sacrifices less in paying taxes, he pays a double income tax. In this case, the tax cannot be denounced under one theory of justice, and defended under another. The double tax on *B* is “unjust” by every conceivable standard.

Overlapping double taxation can exist only when both of two conditions are present. First, judicial construction must impute two or more tax locations to a taxable subject. Income receipt, for example, is construed to occur in both the state where it is earned and the state of the recipient’s domicile. Transfer of tangible personalty on the owner’s death was formerly construed to occur in both the state of its location and the state of the owner’s domicile. And second, the taxing states, eager to reach every dollar of revenue allowed by judicial construction, must levy their taxes

on two or more allowable bases. Overlapping double taxation cannot occur if two states tax income solely on the basis of the recipient's domicile. But if two states tax income on the bases both of derivation and of domicile, or if one uses a derivation basis and the other a domicile basis, some individuals will be caught by the overlapping.

One possibility of eliminating overlapping double taxation would be a reversal of judicial construction to allow only one situs for any taxable item. As was noted in Chapter IX,¹ the Supreme Court recently reversed itself on situs in state inheritance taxation, eliminating double taxation in this field. Many predict a similar limitation of the principle of situs with respect to business and personal income taxation.

Limitation of state taxes to some single base is a second possibility in the elimination of overlapping double taxation. But individual self-denying ordinances are difficult to obtain. Every state expresses willingness to take such action—after neighboring states have done likewise. None the less, a few progressive states can, by reciprocal clauses in the tax laws, initiate a movement to eliminate overlapping double taxation without sacrificing their interests to those of their laggard neighbors. Under a "reciprocal" income tax statute, the levy would be made on the two bases of domicile and derivation. The law would provide, however, that should the income tax law of any other state exempt income earned within its borders by residents of the first state, then the first state would extend a corresponding exemption to income earned within its borders by residents of the other state. Even though other states taxed derived income without providing reciprocal exemption, the first state to adopt a reciprocity clause would sacrifice no part of its revenue. As more and more states made provision for reciprocal exemption of "derived" income, overlapping double taxation of income would be reduced. Before the Supreme Court reconstrued inheritance tax law to provide a single situs for death taxation, reciprocal state action had eliminated most of the overlapping

¹ See p. 215 of this volume.

double taxation in this field. As of 1932, thirty-nine of the forty-seven state death taxes had reciprocity clauses. Sixteen of the state income taxes had such clauses in 1940.

Interstate tax uniformity

No advantage would be sustained if two or more states made their poll or private automobile tax laws identical as to language and administration. No disadvantage is suffered if poll or automobile tax laws vary widely from state to state. A poll-taxpayer or automobile owner is concerned with one tax, and one only—that of the state of his residence or the state of the car's registration—and it does not matter to him if other states employ different forms of the tax and if different judicial constructions are placed on the poll and auto registration taxes of other states. But most taxes may have to be paid in more than one state by a larger or smaller number of taxpayers. An individual may pay income tax not only to the state of his residence, but to several others from which he derives elements of income. The executor or administrator of an estate must prepare forms and pay taxes in the state of the deceased's residence and in every state where any of the real or tangible property is located. Gasoline distributors may be responsible for initial payment of gasoline taxes in the several states in which they do business. And—most important of all—incorporated enterprises must pay special taxes in every state in which they do business.

Nonuniformity of state tax laws is responsible for some of the overlapping double taxation noted in the preceding pages. Each different basis on which a taxpayer must calculate tax liability means an additional accounting calculation, and hence an addition to tax compliance costs. And dissimilar tax statutes lead to variant judicial constructions, further adding to the taxpayers' worries and troubles. While interstate uniformity in tax laws is not as absolutely necessary as uniformity in negotiable instrument laws or sales laws, it would at the very least be a trouble-saving and money-saving convenience to many taxpayers.

To achieve interstate tax uniformity, it is not necessary that every

state impose exactly the same taxes at exactly the same rates. Each state has its own particular revenue needs, and its own special choice as to the distribution of tax burdens among economic and social groups. Uniformity could not extend to identity of tax rates and exemptions, or even to identity in the taxes imposed. If a state chooses to levy a regulatory chain store tax, and courts approve, it should be free to impose the tax. But the basis of any one kind of tax should be uniform from state to state, the included and excluded elements should be reasonably uniform, the language of the laws should be identical, the regulations should be identical, and the tax return forms should be identical in all points except the calculation of the tax on the basis of the statutory rate.

Interstate tax uniformity has long been held a desideratum, but positive action in that direction has been delayed. As long ago as 1901 the National Civic Federation called a conference on taxation to obtain "more uniformity and interstate comity" in tax systems, the conference bore no fruit. In 1902 the Commissioners on Uniform State Laws appointed a committee on uniform taxation, which in 1928 produced a Uniform Reciprocal Transfer Tax Act. A "model tax plan" committee appointed by the National Tax Association reported in 1919;² its report was discussed for thirteen years, a new committee was appointed in 1932, and a second, comprehensive report was made in the year following.³ Recently the Interstate Commission on Conflicting Taxation, the Council of State Governments, the Tax Revision Council, and other national associations of state legislators and officials have conducted research on and given consideration to the problems of uniformity. What is still lacking is a series of model uniform tax laws—a model uniform sales tax law, a model uniform personal income tax law, a model uniform gasoline tax law, and so forth—each complete except for rate and exemption provisions, and ready for word-for-word enactment.

If and when that vital first step of formulating model uniform tax

² "Preliminary Report of a Committee of the National Tax Association on a Model Plan of State and Local Taxation," *Proceedings of the Twelfth National Tax Association Conference*, 1919, p. 426 ff.

³ "Second Report on a Plan of a Model System of State and Local Taxation," *Proceedings of the Twenty-Sixth National Tax Association Conference*, 1933, pp. 353-420.

laws is taken, it will be but a beginning in the movement towards uniformity. Afterwards, all interested organizations will have to make concerted drives to persuade the state legislatures actually to enact the model laws. And finally, when and if uniform tax laws are on the statute books, the various associations of state tax officials will have to formulate a procedure for maintaining uniformity of regulations and report forms.

Interstate tax competition

Real property cannot be moved from one state to another to avoid tax burdens. But some elements of tangible personalty are shiftable. In choosing states of incorporation, and when locating factories and offices, corporations can take relative tax burdens into account. Some wholesale and even retail sales transactions can be effected in one state or another according to the relative tax liabilities involved. And men of wealth can choose their states of domicile with a view to minimizing income and death taxes.

For most state taxes, the margin of taxpayers who can shift from one jurisdiction to another is so small that high-taxing and low-taxing states cannot be said to compete with each other. When one state imposes a sales tax, or a gasoline tax, or a tobacco products tax, and its neighbor does not, some residents living close to the boundary line will go to the trouble of making purchases in the nontaxing state, but these few lost purchases do not seriously threaten either the revenue of the taxing state or its economic structure. Business enterprise migration to minimize taxes has been exaggerated by pressure-group propaganda; the tax factor is actually a very minor one in determining business location.⁴

Progressive personal income and death taxes, however, are peculiarly vulnerable to competitive interstate rate cutting. Personal domicile is so superficial a legal fiction that an American not rigorously tied to a particular community may with little trouble establish residence in almost any state of his choosing. Yet this casual fiction determines whether a millionaire pays \$60,000 a year or more in income tax to New York, or no income tax to Florida.

⁴ See p. 359 of this volume.

Rich residents, for all that their domicile may be largely a nominal matter, bring a degree of prosperity to a state. They buy property, build homes, and make purchases in the state; they give personal service employment to local labor. These advantages have been sufficient to induce Florida, Nevada, and some other states to advertise themselves as "tax havens" for millionaires who wish to avoid state income taxes. Before the federal estate tax credit was enacted⁵ they also advertised themselves as havens for death tax avoidance. Since wealthy individuals to whom these lures are addressed are an exceptionally mobile class, the existence of such "tax havens" is a powerful check on states which might wish to impose sharply progressive income taxes with high rates on high bracket income.

Calling the "tax haven" states "fiscal hijackers" may relieve the feelings of proponents of progressive income taxation in other states, but it does not end the competition of the "havens." And the liberty of an individual to change the state of his residence cannot be abridged. High-income-taxing states have no defense against this cut-rate competition; they can only reduce the rates on large incomes under their own tax laws to a point where the lure of the "havens" can no longer operate. Protection of their tax systems can come only from the outside, by a federal "credit clause." State death taxes were preserved by such a credit clause in the 1920's. Representatives of income-taxing states have on numerous occasions expressed themselves in favor of a similar clause in the federal income tax

Tax barriers to interstate commerce⁶

Prior to 1930, the federal Constitution seemed to be an effective barrier to state taxation that might interfere with interstate commerce. Indeed, the complaint was that the Supreme Court had extended its construction of the interstate commerce limitation so wide that it interfered with legitimate and nondiscriminatory business taxation. But the Twenty-first Amendment adopted in 1934 to re-

⁵ See pp 469 and 759 of this volume

⁶ This subject is most fully covered in *Tax Institute, Tax Barriers to Trade* (The Institute, Philadelphia, 1941).

peal the Eighteenth (Prohibition) Amendment, provided that once alcoholic beverages entered the state of destination, state regulation supersedes federal; this allows the states to impose liquor import duties. And in the course of the 1930's the Supreme Court relaxed its interpretation of the interstate commerce rule with respect to use taxes⁷ so that these levies could be applied to goods brought into the taxing state.

These changes in constitutional law coincided with a wave of economic provincialism that swept the country during the 1929-1933 depression. Each state sought to retain *its* market for *its* farmers and manufacturers, by shutting out the competing products of other states. Many states perverted their police powers over highway traffic and quality control of goods to hinder "outside" shippers and the movement of "outside" goods into their areas. Two types of taxation—motor vehicle license charges on carrier trucks and liquor taxes—were adapted to the same end. Incidentally, a third tax—the use tax developed during the 1930's as a supplement to sales taxes—could also, under certain circumstances, exercise a deterrent effect on interstate trade.

Most of the states deliberately use their liquor license and sales taxes to protect their own industries. Forty states impose special license taxes ranging from \$50 to \$1000 on out-of-state producers selling to in-state wholesalers. Ten states impose higher license taxes on domestic wholesalers who handle out-of-state brands than on those who sell domestic brands exclusively. Eight states have higher sales tax rates on out-of-state liquors than on domestic liquors. As a special form of protection for their farmers, more than a dozen states impose lower tax rates on liquor made with domestic grain. Not infrequent are reciprocity arrangements between particular states, whereby each applies the in-state rates to the other's product, while maintaining high rates for all other out-of-state liquors.

Motor vehicle license charges are also being used to "protect" local carriers against out-of-state competition. This is accomplished in three ways: (1) by imposing multiple fees on interstate carriers; (2)

⁷ See pp 222 and 564 of this volume

by imposing discriminatory ton-mile taxes on interstate carriers, enforced through "ports of entry" which themselves constitute a barrier of delay to interstate commerce; and (3) by imposing special taxes on merchant truckers. This form of state "protection" has progressed to the point where various pairs and groups of states have engaged in "border wars," blocking the entry of each other's carrier trucks on the excuse of enforcing their own tax laws. Such a "border war" flared intermittently through the 1930's between Illinois and Wisconsin; Pennsylvania and New Jersey engaged in such a struggle in 1932, Virginia and West Virginia in 1935. These "fiscal wars" mean expense and delay to the shippers involved, and upon occasion have resulted in the loss of tremendous values of perishable goods.

The use tax, as previously described,⁸ is intended as a method of equating the tax-burden on out-of-state goods with that imposed by retail sales taxes, gasoline taxes, tobacco taxes, and other sales levies on in-state goods. To the extent that a use tax truly equates tax burdens, it does not constitute a barrier to interstate trade. But if the commodity entering the state has already paid a sales tax in the state of its origin, the double burden does handicap it in its competition with in-state goods, and interstate commerce is checked. This barrier effect of use taxes can be prevented by a provision allowing a credit against the use tax for any sales tax paid on the commodity in the state of origin. Some use taxes carry this provision, but this is exceptional.

There can be no question but that these tax barriers to interstate trade are harmful from a national point of view. Any local gain to one state is offset by a corresponding or greater loss to other states. Every commentator agrees that the movement must be checked. Happily, it is possible to report that a strong countermovement to thwart the "state protectionists" has set in, which has already had considerable success. The Council of State Governments has made the elimination of tax and other interstate trade barriers a leading item on its agenda. In this effort it has had the active assistance of

⁸ See p. 564 of this volume.

the Business Advisory Council of the Department of Commerce, the United States Chamber of Commerce, the American Bankers Association, the National Association of Manufacturers, the Tax Institute, the National League of Women Voters, and various consumer and labor organizations. In 1939 it succeeded in having a number of tax barrier provisions repealed by various state legislatures. Commissions on Interstate Cooperation, consisting of representatives from the state senates, state assemblies, and state administrative departments, have been formed in most of the states and are continuing the movement for repeal of these barriers.

FEDERAL-STATE FISCAL RELATIONSHIPS

Overlapping of federal functions and revenues with those of the state and local governments is a relatively recent phenomenon. During the nineteenth century, as has been noted earlier, the service activities and revenues of each class of government were distinctly separate. Functional interpenetration resulted from state activity in agricultural aid and conservation, fields previously occupied by the federal government, and federal activity in arterial motor highways and criminal investigation, services previously provided by state and local governments. A climax in the mingling of federal, state, and local functional interests was reached in the handling of relief efforts from 1933 to 1937.

Federal and state-local sharing of a function may take either of two forms. The federal government may engage directly in some phase of the function. Usually the federal agencies limit themselves to extra-state phases, and so avoid duplicating or overlapping state-local efforts. Duplication has occurred in many instances, however, involving waste of public funds, failure to provide unified control, and conflicts of authority. This has been true to a minor degree in the fields of agricultural aid and criminal investigation, to a major degree in the recent relief program. Or the federal government may leave the administration of a function entirely to state or local agencies, and content itself with distributing grants-in-aid to the state and local units to compensate them for the extra-state elements of their

activity and to establish federal control over these elements of the function.

It is in the revenue field that federal-state fiscal discord is most acute. When the federal government levied personal income, death, corporation, and gasoline taxes, it encroached upon fields pre-empted by the states. When the states imposed liquor and tobacco products taxes, they trespassed upon fields previously considered to belong to the federal fiscal domain. In thus establishing duplicate revenue systems, the federal government and the states limit each other's revenue resources, impose double tax and reporting burdens upon various classes of taxpayers, and maintain duplicate administrative systems. The arrangement is wasteful and unfair, and has led to a growing pressure for reform. A subcommittee of a Joint Congressional Committee on Internal Revenue Taxation studied the problems of duplicate federal-state taxation for many years. The federal Treasury has investigated the subject. The Interstate Commission on Conflicting Taxation, the Tax Revision Council, and the Council of State Governments, previously mentioned, have held meetings on the subject, and the problem also appears on the agendas of such organizations as the National Tax Association, the Tax Institute, and the Federation of Tax Administrators.

The reforms proposed—separation of revenue sources, shared taxes, tax credits, supplementary rates, and grants-in-aid—parallel in some respects the solutions proposed for the state-local revenue problem. But there is a big difference between the state-local and the federal-state tax issues. State-local revenue problems stem largely from the circumstances that the property tax is the only important tax amenable to local administration, and that this tax is insufficient to cover revenue needs. As between the states and the federal government, both are capable of administering most of the taxes in dispute. The federal-state problem is not one of *providing* the states with revenue but of *allowing* them a *sufficient* revenue. As a supplementary point, federal intervention is sought in some quarters as a means of eliminating interstate double taxation and interstate tax competition.

Separation of revenue sources

Separation of revenue sources is a possible solution of the federal-state revenue problem. Unfortunately, proposals for separation nearly always provide for the federal government's surrender of various taxes to the states, without any compensating surrender by the states to the federal government. And since at present the federal government's need for revenue is every bit as pressing as the states', nothing is likely to be accomplished along this line. Both parties must make sacrifices if separation is ever to be achieved.

Some writers argue that because some states levied corporation, personal income, and gasoline taxes before the federal government did, these taxes should be turned back to the states. This "priority" argument is so fatuous that it casts undeserved discredit on the principles of separation. When and if separation is accomplished, a primary consideration, if the arrangement is to be sound, will have to be the respective merits of federal and state administration of certain types of taxes, and the suitability of such taxes to the federal or state tax systems.

On the basis of administrative considerations, the Interstate Commission on Conflicting Taxation recommended in 1934 that the federal government surrender the taxation of gasoline and electrical energy to the states, and that in compensation, the latter surrender tobacco and liquor taxation to the federal government.⁹ This is a sound proposal, although some writers feel that the federal government is better equipped to levy a gasoline tax since it can collect from the refiners, whereas the states can collect only from the distributors. If sales taxes are to be levied, on administrative grounds they should be left to the federal government, which can impose a manufacturers' excise; state retail tax administration is of necessity both costly and weak. The federal government would also be the logical agency to administer corporation taxes. An exclusive federal corporation tax would eliminate the heavy compliance costs borne by corporations, which must prepare multiple and multiform

⁹ Interstate Commission on Conflicting Taxation, *Fiscal Coordination through Intergovernmental Agreement*, 1934.

reports for various state jurisdictions. Good state administration is more effective than federal in the taxation of small incomes and estates; federal administration is superior for large incomes and estates. Personal income taxation could, therefore, be separated into two parts, the federal government having exclusive taxing jurisdiction over incomes in excess—let us say—of \$25,000, while the states have exclusive jurisdiction over the mass of small incomes. For death taxes, the dividing line could be the \$100,000 estate.

Several other considerations enter if the principle of separation is applied to income or death taxation. High income tax rates on large incomes, and high death duty rates on large estates, produce a very uneven revenue. Their yield is extremely sensitive both to business cycle swings and to the hazards and chances which govern individual incomes and estates. The smaller the taxing jurisdiction, the fewer are the incomes and estates involved, the less is the likelihood of averaging out individual hazards and chances through large numbers, and hence the more variable is the tax yield. For these reasons, the taxation of large incomes and estates would fit better into the federal tax system than into the state systems. Furthermore, the flexibility of the federal government's borrowing and debt retirement technique would enable it to accommodate itself to the fluctuations of large-income and large-estate tax yields in a manner impossible for the state governments. Finally, if the states are restricted to taxing small incomes and small estates, the possibility of cut-rate tax competition among them will be minimized, for mobility of residence is greatest among recipients of large incomes and owners of large estates.

Partial federal-state separation of revenue sources on a *quid pro quo* basis, with due consideration of administrative capacities and tax characteristics, has much to recommend it. It will give the states greater freedom in modeling their tax systems, it will end the widespread dissatisfaction with superimposed tax burdens, and it will end the uneconomic duplication of administrative machinery and tax reporting. But it is far from being a complete solution of the federal-state revenue problem. Administrative considerations would dictate turning most of the large-yield taxes over to the federal government,

leaving the states even harder pressed for revenue than they are to-day. Moreover, the separation of federal and state revenue sources will not achieve some of the objectives of other federal-state fiscal devices to be considered later. It will not create the interstate uniformity of taxation which would result from a system of supplementary state rates, or which could be enforced by a system of federal tax credits. Nor will it give the federal government the elements of control over state revenue systems and extra-state elements of state functions which can be obtained through a system of federal tax credits or federal grants-in-aid. And it is not possible to equalize state resources through the separation of federal and state revenues, as it is through grants-in-aid.

Shared taxes

Frequently proposed has been state surrender of certain disputed taxes to the federal government on condition that the states receive a share in the revenues collected from these taxes, just as the states share their income, corporation, gasoline, and other taxes with their local governments. One specific proposal—the so-called Graves-Edmunds plan—would establish the following system of federal-collected, state-shared taxes:

1. A \$3 per gallon liquor tax, one-half returned to the "wet" states partly on the basis of population and partly on the basis of the present state-local liquor license collections in those states.
2. A 4-cent gasoline tax, $3\frac{1}{2}$ cents to go to the states one-third in proportion to population, one-third in proportion to motor registration, one-third in proportion to improved road mileage.
3. A 6-cent cigarette package tax, one cent distributed in proportion to population to the states permitting cigarette sales.
4. A 5 per cent manufacturers' excise, two-fifths to be distributed to the states in proportion to population, and two-fifths in proportion to "true" property valuations.¹⁰

A shared-tax system would eliminate double administration and reporting and might, if the federal government were generous enough, give the states more revenue from the shared taxes than they

¹⁰ "Report of Committee on Fiscal Relationships of Federal and State Governments," *Proceedings of the Twenty-Seventh National Tax Association Conference*, 1934, p. 166.

are at present deriving from their own levies. It would be a logical step subsequent to a separation of revenue sources which for administrative reasons gave the federal government most of the large-yield taxes and left the states with inadequate systems of small-yield taxes. But under a shared-tax system, each state's share would necessarily be determined by the arbitrary basis of distribution, not by the state's revenue needs. Some states might receive more than they needed in view of their functional expenditure requirements, other states less. All states would be relieved of direct responsibility to the taxpayers, and this circumstance might encourage extravagance in spending the sums at their disposal.

In some ways, it would be easier to choose the bases of distribution in federal-state tax sharing than in state-local sharing, in some ways it would be more difficult. There is not the extreme unevenness in the spread of population, property, tax collections, and other standards of distribution among states that there is among localities; hence there would not be the disturbing unevenness in the distribution of the shared revenue so frequent in systems of state-local sharing. But if income tax revenue were to be distributed on a source basis, which "source" should be the basis—the state of the taxpayer's residence or the state of the income's origin? Whichever the "source" chosen, some states would lose, and they could not be expected to view the system with marked approval.

Finally, unlike the states in connection with their local governments, the federal government could not force a general system of tax sharing on all the states. Nominally, at least, the sharing arrangement would have to rest on a voluntary basis. It would operate only for those states which consented to surrender their own taxes of the type covered by the sharing arrangement. Nor could the federal government collect a higher-rate tax in the sharing states and a lower-rate tax in the nonsharing states, since this would be contrary to the "uniformity" clause of the federal Constitution. The same rate schedule would have to apply in all states, even in those which might not have entered the sharing arrangement. Tremendous pressure would thus be brought to bear on all states to enter the sharing arrangement, since taxpayers in nonsharing states would,

have to pay the higher-rate federal tax, though these states would receive no part of the revenues contributed by their taxpayers. Despite the superficial appearance of a voluntary arrangement, therefore, the federal government would be subject to the charge of fiscal coercion of the states.

Supplementary state rates

To avoid the elements of state coercion and arbitrary revenue assignment involved in federal-state tax-sharing, some fiscal economists have proposed a system of supplementary state rates superimposed on taxes administered and collected by the federal government.¹¹ As in shared-tax arrangements, administration and collection would be left entirely to the federal government. Each state would add such supplementary rates as it chose to impose on the basic federal rates, uniform throughout the country. These supplementary state rates would be collected by the federal tax administration together with its own taxes, and the sums involved would be remitted to the states.

Like the shared-tax arrangement, the supplementary rate plan would eliminate duplicatory federal and state administrative machinery and interstate diversity of tax bases. And, as already mentioned, there would be no direct or indirect coercion on the states to forego their own taxes and accept an arbitrary revenue sum unrelated to their revenue needs. Each state's supplementary rate would represent the choice of its own legislature, made in the light of its revenue needs. A state which desired no part in this cooperative arrangement could stay out—impose its own tax, or impose no corresponding tax of its own, at its choice—without its taxpayers being subjected to any extra tax burden. The only constraint involved is, that all states concurring in the arrangement would have to accept the basis of the federal tax as the basis for their own supplementary levies, and this would be a voluntary matter.

But the plan has its weak points. It could not apply to certain

¹¹ See Edwin R. A. Seligman, "The Fiscal Outlook and the Coordination of Public Revenues," in New York University Symposium, *Current Problems in Public Finance* (Commerce Clearing House, Chicago, 1933), p. 273

important taxes. State supplements could not be added to federal excises on tobacco or liquor manufacturers, or to a general federal manufacturers' excise, since the uneven distribution of the bases of these taxes as between states makes them unsuitable for state levy. Taxpayers' residence would have to be the basis for state supplementary levies in the case of personal income taxes; any attempt to levy state income tax supplements on the basis of the source of the income would either open a door to evasion or so complicate the administration of the tax as to offset other advantages of the arrangement. Many states which now employ "origin" as sole or partial basis for their income taxes would look with disfavor on any federal-state arrangement depriving them of this element of their income taxation. Finally, state supplementary rates in personal income and death taxes would have to be decidedly moderate, as otherwise the menace of interstate tax competition would again be raised.

State credits against federal taxes

Since 1924, as described in an earlier chapter,¹² the federal government has allowed payments made on state death taxes as a credit, within prescribed limits, against its own estate tax. Under the Social Security Act of 1935, a similar credit arrangement was established for state unemployment insurance payroll taxes and the federal payroll tax.¹³ Proposals are made occasionally for a credit allowance on the federal income tax,¹⁴ the stock transfer tax,¹⁵ and other federal levies.

A credit arrangement unquestionably divides the revenues from a tax between the federal government and the states. As a revenue-sharing device, however, the credit is most inefficient. Duplications of tax administration and diversity of state tax bases continue, although their elimination is one of the primary advantages of separation of sources, shared taxes, or supplementary state rates. There

¹² See p. 469 of this volume.

¹³ See p. 532 of this volume.

¹⁴ See Interstate Commission on Conflicting Taxation, *The Personal Income Tax and the Crediting Device*, Chicago, 1935.

¹⁵ See Committee for the Study of Federal and State Stock Transfer Laws, *The Problem of Stock Transfer Taxation in the State of New York* (the Committee, New York, 1938), p. 60.

would be little to recommend the credit arrangement were revenue-sharing its only accomplishment. But the credit arrangement has an ulterior motivation not present in any of the other federal-state tax devices so far considered—it is an instrument of coercion whereby the federal government can more or less compel the states to levy particular types or forms of taxes. A state which fails to levy the kind of tax allowed as a credit saves its taxpayers nothing. They pay the same amount of tax, only the federal instead of the state treasury receives the revenues. Under such circumstances, the failure of a state legislature to levy a credited tax is either extra-high-minded idealism or blind obstinacy—in either case, a rather rare legislative phenomenon.

The coercion involved in the federal estate tax credit was the elimination of interstate rate-cutting competition in the inheritance tax field, in order to preserve this tax as a substantial source of state revenue. In the case of the payroll tax credit, the states have been compelled to levy their own payroll taxes to provide revenue for their unemployment insurance systems. Credit arrangements have been proposed in the corporation and personal income tax fields with a view to forcing interstate uniformity in their levy. Opinion on the propriety of such fiscal coercion is sharply divided. Writers who consider the independence of the states as against the federal government a desideratum to be maintained at all costs, unqualifiedly condemn all credit arrangements. Those who consider elements of state independence well worth sacrificing for various objectives which can be obtained only by such sacrifice, approve the estate and payroll tax credits and would welcome further extension of the device. Here are two schools of thought based on diametrically opposed political premises, capable of neither proof nor disproof, and no valid judgment can be made between them.

Grants-in-aid ¹⁶

The last type of federal-state fiscal interrelationship, the federal grant-in-aid, has been employed in this country for over fifty years.

¹⁶ Recent studies on the subject are Henry J. Bittermann, *State and Federal Grants-in-Aid* (Mentzer, Bush & Co., New York, 1938), Jane P. Clark, *The Rise of a New Federalism* (Columbia University Press, New York, 1938), Chs. VI-VIII,

While federal grants-in-aid may be viewed as an arrangement for easing the fiscal burden on the states, their primary motivation has been to secure the cooperation of the states in introducing and developing services which have become national in scope and which the federal administration desires to foster. Under the Hatch Act of 1887 each state and territory was offered a \$15,000 federal allowance annually to establish and maintain agricultural experiment stations. Beginning in 1890, annual grants were made to the states to aid their agricultural colleges. Federal money was voted for agricultural education in 1914, and for vocational education in 1917. In 1911, Congress made a first appropriation for federal aid in forest fire protection. Federal contributions to the maintenance and equipment of the National Guard were placed on a grant-in-aid basis in 1916. In the same year the Federal Aid Road Act made appropriations for highway aid.

Until 1922, however, the amounts involved in these various federal aid grants were trifling. Contributions from 1920 on to assist state activity in vocational rehabilitation of disabled individuals, grants from 1921 on to aid state efforts to improve infant and maternity hygiene, and an increase in federal highway aid in 1921, expanded federal aid during the 1920's to a substantial sum. By the second half of the decade, federal grants-in-aid exceeded \$100,000,000. The general policy of federal aid came under a heavy fire of criticism during the 1920's however, and the system was not extended during the Coolidge and Hoover administrations.

Beginning in 1933, the federal grant-in-aid system was tremendously expanded. A considerable part of the Roosevelt "recovery and relief" program was accomplished through grants, not only to the states but to local units of government. Much of the social security program established by the act of 1935 has been placed on a grant-in-aid basis. The pre-existing systems of highway and agricultural education aid have been increased in recent years. Federal grants-in-aid exceeded \$2,000,000,000 in 1935, most of it to local units. Grants to the states have been temporarily stabilized, since 1938, at the \$600,000,000 level.

No conditions other than the general purpose in view were at-

tached to the early federal grants-in-aid paid to the states. No obligations were imposed on the recipient states, and no federal administrative machinery was established to supervise expenditures or work programs. Commencing with the forest preservation grants in 1911, Congress imposed definite conditions, including state ap-

TABLE 42
FEDERAL GRANTS TO THE STATES, SELECTED
YEARS 1915-1940
(Amounts in millions)

| Year | High-ways | Edu-cation | Agri-culture | Relief | Other | Total |
|------|-----------|------------|--------------|---------|--------|--------|
| 1915 | | \$ 2 8 | | | \$ 2 6 | \$ 5 4 |
| 1919 | | 4 8 | | | 6 9 | 11 7 |
| 1925 | \$ 92 1 | 11 8 | \$ 7 5 | | 2 3 | 113 6 |
| 1930 | 83 3 | 11 9 | 12 9 | | 1 8 | 109 8 |
| 1932 | 188 5 | 13 2 | 12 8 | | 2 6 | 217 1 |
| 1937 | 317 4 | 24 8 | 21 8 | \$155 1 | 45 7 | 564 8 |
| 1938 | 235 0 | 33 2 | 23 4 | 215 2 | 120 8 | 627 6 |
| 1940 | 120 2 | 27 1 | 32 8 | 411 1 | 3 6 | 594.9 |

From United States Bureau of the Census, *Financial Statistics of States, 1938*, 1940 figures from United States Secretary of the Treasury, *Annual Report*, pp 823-825

propriations of sums equal to those contributed by the federal government, and federal approval of the activities supported by a joint fund. Agricultural extension grants under the Smith-Lever Act of 1914 were conditioned upon state acceptance by legislative assent, and upon approval of the work program by the federal government. Federal control through grants-in-aid was carried a step further under the highway aid act of 1921, which authorized the Secretary of Agriculture to cooperate with the state highway departments in designating a system of main interstate and intercounty highways, eventually to total about two hundred thousand miles, to whose construction and maintenance the federal aid should be applied; state work on these roads had to conform with federal standards. Practically all ultimate responsibility for the functions involved has been transferred from state to federal agencies by the terms of some of the recent social security grants.

Though the principle of equalization occupies an important place

in state-local grants-in-aid, it was until recently given little consideration in federal-state aid. Prior to 1933, stimulation of state activity in particular fields, or purchase of control over particular state functions, were the primary motivations for federal grants-in-aid. Federal grants were made on a "matching" basis—the federal government contributing toward some function the same amount as the state appropriated—or the federal government contributed some fraction of the total cost of a function. The tremendous emergency relief grants of 1934, 1935, and 1936, however, took into consideration local variations in relief needs, costs of giving relief, and ability to finance it. Some of the cost and need factors determining the distribution of these funds were the relief load, geographical variations in living standards and relief costs, and relative amounts spent by local units for welfare purposes other than direct relief. On the "ability" side, ten indices—including number of gainfully employed, reported income, volume of retail sales, volume of wholesale sales, and motor car registrations—were utilized. Case studies were made of economic conditions in each locality, and consideration was given to existing state-local debt burdens and to the yield which would result from the application of a uniform tax system to all of the states.

Federal-state grants-in-aid are apparently developing along lines parallel to state-local grants-in-aid. They appear where states are administering functions having extra-state significance. Through grants-in-aid, the federal government purchases various elements of control over these functions, even to the extent of dictating civil service requirements for the state personnel and planning budgets for the aided state activities. So long as the aid funds being distributed were relatively small, the bases of distribution were designed to stimulate rather than equalize state activity in these fields. When large aid funds were made available, as in the relief grants, the element of equalization had to enter. And the same insoluble controversy arises over the issue of control in connection with federal-state grants as with state-local grants—to what extent, if any, should state or local functional independence be surrendered to higher authority?

SUGGESTED READINGS

Suggested Readings

THE following classified list of titles is presented as a students' guide to American fiscal writing. Excluded from it are (1) foreign writings, except a few English books of outstanding influence on American fiscal thought, (2) older American books which have been superseded by more recent studies, (3) magazine articles, unless of exceptional value, (4) reports of fiscal officials and the large and growing number of official reports and monographs on the fiscal problems or fiscal history of particular states, and (5) studies not widely available.

A. GENERAL (INTRODUCTION)

1. Textbooks

- Buehler, Alfred G., *Public Finance*, McGraw-Hill Book Co., New York, 2nd ed., 1940
Groves, Harold M., *Financing Government*, Henry Holt & Co., New York, 1939
Jensen, Jens P., *Government Finance*, Thomas Y. Crowell Co., New York, 1937.
King, Clyde, *Public Finance*, The Macmillan Co., New York, 1935
Lutz, Harley L., *Public Finance*, Appleton-Century Co., New York, 3rd ed., 1936
Studenski, Paul, *Chapters in Public Finance*, Long & Smith, New York, 1933.
(A condensed text, originally part of a general economics text.)

2. Collections of readings

- Bullock, Charles J., *Selected Readings in Public Finance*, Ginn & Co., Boston, 3rd ed., 1924
Fagan, Elmer D., and Macy, C. Ward, *Public Finance*, Longmans, Green & Co., New York, 1935.
Mills, Mark C., and Starr, George W., *Readings in Public Finance*, The Macmillan Co., New York, 1932

3. General studies

- Bastable, Charles F., *Public Finance*, The Macmillan Co., New York, 3rd ed., 1903. (The springboard for most American and English fiscal theory.)
Crow, William H., and Greene, U. S., *Planning for Tax Economy*, Waldrep-Tilson, New York, 1936. (A "minimizing taxes" manual).
"Government Finance in the Modern Economy," *Annals of the American*

- Academy of Political and Social Science*, January 1936 (General articles by authorities)
- Green, William R., *Theory and Practice of Modern Taxation*, Commerce Clearing House, Chicago, 1933 (A "common-sense" analysis)
- Heer, Clarence, "Trends in Taxation and Public Finance," in *Recent Social Trends in the United States*, McGraw-Hill Book Co., New York, 1933, Vol. II, pp 1331-1390
- Hodes, Barnett, *It's Your Money*, Reilly & Lee Co., Chicago, 1935 (A popular little study based on Chicago tax situation)
- Howard, Mayne S., *Principles of Government Finance*, Commerce Clearing House, Chicago, 1940
- Kendrick, M Slade, *Taxation Issues, with Special Reference to State and Local Problems*, Harper & Bros., New York, 1933.
- Kendrick, M Slade, and Seaver, Charles H., *Taxes Benefit and Burden*, Newson & Co., New York, 1937 (A popular presentation)
- Lutz, Harley L., *The Business Man's Stake in Government Finance*, Stanford University, 1940 (Collection of lectures, presenting conservative criticism of New Deal fiscal policies)
- Mellon, Andrew G., *Taxation the People's Business*, The Macmillan Co., New York, 1924 (Popular analysis by the then Secretary of the Treasury)
- New York University Symposium, *Current Problems in Public Finance*, Commerce Clearing House, Chicago, 1933 (A valuable collection of addresses by fiscal scholars)
- Newcomer, Mabel, *Taxation and Fiscal Policy*, Columbia University Press, New York, 1940. (A "layman's survey.")
- Peck, Harvey W., *Taxation and Welfare*, The Macmillan Co., New York, 1925 (An effective analysis of various points of theory)
- Pigou, Arthur C., *A Study in Public Finance*, The Macmillan Co., New York, 1928 (Effective presentation of conservative fiscal theory.)
- Seligman, Edwin R A., *Essays in Taxation*, The Macmillan Co., New York, 10th ed., 1925. (Collected essays of an eminent scholar)
- Seligman, Edwin R A., *Studies in Public Finance*, The Macmillan Co., New York, 1925 (Collected essays of an eminent scholar.)
- Shultz, William J., *Your Taxes*, Doubleday Doran, New York, 1938. (A popular analysis)
- Studenski, Paul, *Taxation and Public Policy*, Richard R. Smith, New York, 1936.
- Twentieth Century Fund, *Facing the Tax Problem*, New York, 1937. (General, with important sections on taxable capacity, regulatory taxation, justice, and fiscal and administrative considerations)
- Twentieth Century Fund, *Studies in Current Tax Problems*, New York, 1937 (Estimates of tax burden, trends of expenditures, administrative problems.)
- Untereiner, Ray E., *The Tax Racket, What We Pay to Be Governed*, Lippincott Co., Philadelphia, 1933 (Popular presentation.)

4. Periodical materials

- International City Managers Association, *Municipal Yearbook*. (Annual compilation covering municipal finance)
- National Municipal League, *National Municipal Review*. (Monthly, covers municipal government and finance)
- National Tax Association, *Bulletin*. (Monthly organ of the association, valuable current articles)
- National Tax Association, *Proceedings of the Annual Conferences*, 1907 to date (Valuable source for special papers and committee reports)
- Tax Foundation, *The Tax Review*. (Monthly to promote fiscal economizing.)
- Tax Institute (formerly Tax Policy League), *Tax Policy* (formerly *Tax Bits*), 1933 to date. (Monthly tabulations and articles on tax matters.)
- Tax Research Foundation, *Tax Systems of the World*, biennial. (Invaluable current tabulations of American and foreign taxes)
- Taxes* (formerly *The National Income Tax Magazine*), Commerce Clearing House, 1923 to date.

5. Sources of fiscal statistics

- Annual and biennial reports of state tax commissions, finance departments, comptrollers, treasurers, and other fiscal administrative agencies.
- National Industrial Conference Board, *Cost of Government in the United States* series, 1926 to date. (Analyzed statistics on expenditures, taxation, borrowing, and debt)
- United States Bureau of the Census, *Financial Statistics of Cities with Populations over 30,000* series, 1904 to 1931; *Financial Statistics of Cities with Populations over 100,000* series, 1931 to date, *Financial Statistics of States* series, 1915 to date, *State Tax Collections*, 1939 to date. (Source for statistics on state and municipal expenditures, debt and taxation)
- United States Bureau of the Census, *Wealth, Debt and Taxation* series, 1890, 1903, 1912, 1922, *Financial Statistics of State and Local Governments*, 1932. (Source for decennial statistics on state and local expenditures, debt, and taxation)
- United States Secretary of the Treasury, *Annual Reports* (Source for statistics on federal expenditures, borrowing, debt, and taxation)
- United States Social Security Board, *Annual Reports*. (Source for federal and state social welfare expenditures)

6. Tax services

- Commerce Clearing House, *Corporation Tax Service; Federal Tax Services; Inheritance, Estate, and Gift Tax Service*, and *Unemployment Insurance and Old Age Benefit Tax Services*.
- Prentice-Hall, Inc., *Federal Tax Services; Hawaii Tax Service; Inheritance and Transfer Tax Service; Insurance Tax Service; Pennsylvania Taxable Securities Service; Property Tax Service; Sales Tax Service, State and Local Tax Service; State Personal Income Tax Service*, and *Unemployment Insurance and Old Age Benefit Tax Services*.

B. THEORY OF GOVERNMENTAL EXPENDITURE (CHAPTERS I, II)

- Bullock, *Readings* (See under A2), Ch. II.
- Burns, Arthur E., and Watson, Donald S., *Government Spending and Economic Expansion*, American Council on Public Affairs, Washington, 1940 (Interesting theoretical analysis of pump-priming and business-cycle-control spending)
- Fagan & Macy, *Public Finance* (See under A2), Chs. III, IV.
- Gayer, Arthur D., *Public Works in Prosperity and Depression*, National Bureau of Economic Research, New York, 1935 (Best analysis of subject)
- Greenwood, Ernest, *Spenders All*, Appleton-Century Co., New York, 1935 (Superficial denunciation of government spending tied to diffusion theory of taxation)
- Guest, Harold W., *Public Expenditures*, Putnam's Sons, New York, 1927. (Standard study on expenditure theory.)
- Hansen, Alvin H., *Fiscal Policy and Business Cycles*, Norton & Co., New York, 1941 (Broad economic analysis of subject.)
- Mills & Starr, *Readings* (See under A2), Ch. II.
- National Industrial Conference Board, *Essential Facts for Fiscal Policy*, the Board, New York, 1941 (Background and analysis of defense finance)
- Peck, *Taxation and Welfare* (See under A3).
- Simpson, Herbert D., *Purchasing Power and Prosperity*, Foundation Press, Chicago, 1936. (Critical study of "planned" expenditure)
- Temporary National Economic Committee, *Government Purchasing—an Economic Commentary*, Monograph No. 19, 1940. (Possibilities of "counter-weight" government expenditure policy.)
- Villard, Henry H., *Deficit Spending and the National Income*, Farrar & Rinehart, New York, 1941. (A Keynesian analysis)

C. AMERICAN GOVERNMENTAL EXPENDITURES (CHAPTERS III, IV)

1. General

- Guest, Harold W., "Public Expenditure Policies and Trends," *Annals of the American Academy*, Vol. 183, January 1936, pp. 12-18 (General analysis)
- National Industrial Conference Board, *Cost of Government in the United States* (See under A5).
- Shultz, William J., and Caine, M. R., *Financial Development of the United States*, Prentice-Hall, New York, 1937. (Contains sections on history of federal, state, and local finances)
- Twentieth Century Fund, *Current Tax Problems* (See under A3).
- Walker, Harvey, *Public Administration in the United States*, Farrar & Rinehart, New York, 1937 (Excellent textbook presentation)

- Mort, Paul R., *Federal Support for Public Education*, Teachers College, Columbia University, Bureau of Publications, 1936. (Plea for federal aid)
- Mort, Paul R., and Reusser, Walter C., *Public School Finance*, McGraw-Hill Book Co., New York, 1941. (Comprehensive textbook)
- Norton, John K. and Margaret A., *Wealth, Children and Education*, Teachers College, Columbia University, Bureau of Publications, 1938 (Study of relative ability of the states to support education)
- U. S. Bureau of Education, *Biennial Census of Education*. (Statistical source.)

5 *Relief and social security*

- Brown, Josephine C., *Public Relief, 1929-1939*, Henry Holt, New York, 1940
- Favinger, C. E. and Wilcox, D. A., *Social Security Taxation and Records*, Prentice-Hall, Inc., New York, 1939.
- Geddes, Anne E., *Trends in Relief Expenditures, 1910-1935*, Washington, 1937.
- United States Social Security Board, *Annual Reports* (See under A5)
- Withers, William, *Financing Economic Security in the United States*, Columbia University Press, New York, 1939.

D. CONTROL OF GOVERNMENTAL EXPENDITURE

(CHAPTERS V, VI)

- The Tax Foundation, *Studies in Economy and Efficiency in Government*, the Foundation, New York, 1941. (A bibliography.)

1. *Administrative organization*

- Buck, Arthur E., *The Reorganization of State Governments in the United States*, Columbia University Press, New York, 1938. (Outstanding, comprehensive study.)
- Compton, Ralph T., *Fiscal Problems of Rural Decline*, New York State, Department of Taxation and Finance, Division of Taxation, Special Report of the State Tax Commission No. 2, Albany, 1929. (Fiscal problem of submarginal communities.)
- Fairlie & Kneier, *County Government* (See under C3).
- MacCorkle, Stuart A., *Municipal Administration*, Prentice-Hall, Inc., New York, 1942.
- Munro, William B., *Municipal Administration*, The Macmillan Co., New York, 1934. (Excellent chapters on financial administration, budget, revenues, tax assessment.)
- Ridley, Clarence E., and Nolting, Orin F., *The City-Manager Profession*, University of Chicago Press, Chicago, 1934. (Excellent brief description)
- Stone, Harold A., Price, Don K., and Stone, Kathryn H., *City Manager Government in the United States*, Public Administration Service, Chicago, 1940. (Comprehensive.)
- Walker, *Public Administration* (See under C1).

- White, Leonard D, *Introduction to the Study of Public Administration*, The Macmillan Co, New York, 1930 (Textbook survey.)
- White, Leonard D., *Trends in Public Administration*, McGraw-Hill Book Co, New York, 1933. (Invaluable survey for period prior to 1931)
- Wrenshall, C M, *Municipal Administration and Accounting*, Pitman Publishing Corp., New York, 1937.

2. Government accounting

- Bartelt, Edward F, *Accounting Procedures of the United States Government*, Public Administration Service, Chicago, 1940.
- Chatters, Carl C., and Tenner, Irving, *Municipal and Governmental Accounting*, Prentice-Hall, New York, 1940. (Outstanding textbook)
- Municipal Finance Officers Association, *Governmental Cost Accounting*, the Association, Chicago, 1940. (A handbook.)

3. Government budgets

- Buck, Arthur E, *The Budget in Governments of Today*, The Macmillan Co., New York, 1934. (Excellent textbook.)
- Chamber of Commerce of the United States, Committee on State and Local Taxation and Expenditures, *State and Local Budgetary Methods*, 1935. (Compact summary)
- Fagan & Macy, *Public Finance* (See under A2), Ch. XXIX.
- Mills & Starr, *Readings* (See under A2), Ch. XXV.
- Selko, Daniel J, *The Federal Financial System*, The Brookings Institution, Washington, 1940. (An able study of federal fiscal administration.)
- Sundelson, J. Wilner, *Budgetary Methods in National and State Governments*, New York State Tax Commission, Special Report No. 14, Albany, 1938. (Most comprehensive study on subject.)
- Tax Systems of the World* (See under A4).
- Walker, *Municipal Expenditures* (See under C3)

4. Central control of local finances

- Allen, H. K., *Control of Expenditures in the Local Governmental Units of Illinois*, University of Illinois, Bulletin No. 61, Urbana, 1940.
- Carr, Robert K, *State Control of Local Finance in Oklahoma*, University of Oklahoma Press, Norman, 1937.
- Kilpatrick, Wylie, "An Inventory of State Supervision of Local Finance," *Annals of the American Academy*, Vol. 183, January 1936, pp. 170-178 (A general survey.)
- Kilpatrick, Wylie, *State Supervision of Local Budgeting*, National Municipal League, New York, 1939. (Excellent analysis.)
- Lutz, Harley L., "State Supervision of Local Finance," *Journal of Political Economy*, Vol. XLIII, June 1935, pp. 289-305. (Good general survey)
- MacCorkle, Stuart A., *State Financial Control over Cities in Texas*, Southern Methodist University, Arnold Foundation, Dallas, 1937.

- Morey, Lloyd, "Possibilities and Problems of Uniform Municipal Accounting," *Proceedings of the Nineteenth National Tax Association Conference*, 1936, pp 386-394
- Van de Woestyne, Royal S, *State Control of Local Finance in Massachusetts*, Harvard Economic Studies, Harvard University Press, Vol XLIX, Cambridge, 1935

5. Miscellaneous

- Commission of Inquiry on Public Service Personnel*, McGraw-Hill Book Co, New York, 1935 (Vols VII-XI on "Problems of the American Public Service," Vol XII, "Government by Merit," a summary of the inquiry)
- Faust, Martin L., *The Security of Public Deposits*, Public Administration Service, Publication No 51, 1936. (A survey.)
- Forbes, Russell, *Governmental Purchasing*, Harper & Bros, New York, 1929. (Standard book on subject, now somewhat outdated on factual side)
- Ridley, Clarence E, and Simon, Herbert A, *Measuring Municipal Activities*, International City Managers Association, Chicago, 1938. (A study of city expenditure standards)
- Tharp, Claude R, *Control of Local Finance Through Taxpayers Associations and Centralized Administration*, Indiana Taxpayers' Association, 1933. (A good survey)

E. GOVERNMENT ENTERPRISES (CHAPTER VII)

- Bauer, John, "Rates and Revenues of Public Enterprises," *Annals of the American Academy*, Vol. 183, January 1936, pp. 70-77 (General principles.)
- Bullock, *Selected Readings* (See under A2), Ch. VI.
- Chase, Stuart, *Government in Business*, The Macmillan Co, New York, 1935. (In support of government enterprises)
- Dimock, Marshall E, *Developing America's Waterways; Administration of the Inland Waterways Corporation*, University of Chicago Press, Chicago, 1935 (A sympathetic analysis.)
- Dimock, Marshall E, *Government-Owned Enterprises in the Panama Canal Zone*, University of Chicago Press, Chicago, 1934. (A sympathetic survey)
- Greenwood, Ernest, *The Great Delusion, Some Facts About Government in Business*, Harper & Bros., New York, 1933. (Condemnatory.)
- Greenwood, Ernest, *You, Utilities, and the Government*, Appleton-Century Co, New York, 1935 (Déunciatory.)
- Kelly, Clyde, *U. S. Postal Policy*, Appleton-Century Co., New York, 1931. (General.)
- McDiarmid, John, *Government Corporations and Federal Funds*, University of Chicago Press, Chicago, 1938. (Primarily on accounting control.)

- Persons, Warren M., *Government Experimentation in Business*, John Wiley & Sons, New York, 1934. (Antagonistic.)
- Pigou, *Study* (See under A3), Pt I, Ch. 6.
- Sorrell, Lewis C., *Government Ownership and Operation of Railways for the United States*, Prentice-Hall, New York, 1937 (An analytical study)
- Splawn, Walter M W., *Government Ownership and Operation of Railroads*, The Macmillan Co, New York, 1928 (Antagonistic)
- Starr & Mills, *Readings* (See under A2), Chs. VII, VIII.
- Thompson, Carl D., *Public Ownership*, Thomas Y Crowell Co., New York, 1925. (In support of government ownership.)
- Wilcox, Delos F., *The Administration of Municipally-Owned Utilities*, Municipal Administration Service, Pub. No. 22, 1931. (A fair, able analysis)

F. LAW OF TAXATION (CHAPTERS VIII, IX)

- Brown, Robert C., "Domicile versus Situs as the Basis of Tax Jurisdiction," *Proceedings of the Twenty-Eighth National Tax Association Conference*, 1936, pp 144-156. (Excellent survey)
- Bullock, Charles J., *Economic Essays*, Harvard University Press, Cambridge, 1936 (Reprint of earlier articles; several on tax law and property tax problems.)
- Cooley, Thomas M., *The Law of Taxation*, Callaghan & Co., Chicago, 4th ed., 1924. (Standard work on the subject, now somewhat outdated)
- Corey, C S., *The Supreme Court and State Taxation of Interstate Commerce*, University of Illinois Press, Urbana, 1933.
- Fletcher, Benjamin, *The Contract Clause of the Constitution*, Harvard University Press, Cambridge, 1938.
- Harding, A L., *Double Taxation of Property and Income*, Harvard University Press, Cambridge, 1933 (Able research, marred by doctrinaire analysis)
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- Hinckley, Russell J., *State Grants-in-Aid*, New York State, Department of Taxation and Finance, Division of Taxation, Special Report of the State Tax Commission, No. 9, Albany, 1935. (Diffuse and somewhat confused.)
- Key, V. O., *The Administration of Federal Grants to States*, Public Administration Service, Chicago, 1937.
- Macdonald, Austin F., *Federal Aid*, Thomas Y. Crowell Co., New York, 1928. (Early work on subject.)
- Mort, *Federal Support for Public Education* (See under C4).
- Williams, J. Kerwin, *Grants-in-Aid under the Public Works Administration*, Columbia University Press, New York, 1939. (Study of a special application of the grant-in-aid.)

3. Shared taxes

- Edmunds, Franklin S., "A Taxing Program for the Nation," *Proceedings of the Twenty-Sixth National Tax Association Conference*, 1933, pp. 30-39. (Recommending federal-levied taxes shared with states.)

Heer, *State-Shared Federal Sales Tax* (See under O3)

Hillhouse, *New Sources* (See under Q2)

Hutchinson, Ruth G, *State Administered Locally Shared Taxes*, Columbia University Studies No. 355, Columbia University Press, New York, 1931. (Comprehensive analysis.)

Newcomer, Mabel, "Revenue Sharing between Federal and State Governments and between State and Local Governments," *Proceedings of the Twenty-Ninth National Tax Association Conference*, 1936, pp. 275-283 (Pros and cons)

4 *Separation of revenues*

Newcomer, Mabel, *Separation of State and Local Revenues in the United States*, Columbia University studies, Vol LXXVI, No. 2, Columbia University Press, New York, 1917. (Early comprehensive study)

5 *Interstate tax relationships*

Edmunds, Franklin S., "Report of Committee on Uniformity and Reciprocity in State Taxing Legislation," *Proceedings of the Twenty-Sixth National Tax Association Conference*, 1933, pp. 259-267

Girard, Richard A, *The Scope for Uniformity in State Tax Systems*, New York State Department of Finance and Taxation, Division of Taxation, State Tax Commission Special Report No. 8, Albany, 1935. (Particularly valuable for sidelights on pressure groups in tax field)

Interstate Commission on Conflicting Taxation, *Fiscal Coordination through Intergovernmental Agreement*, 1934 (Preliminary analysis of problem and possibilities of solution)

Tax Institute, *Tax Barriers to Trade*, the Institute, Philadelphia, 1941. (A symposium)

Todd, Edwin S, "Double Taxation," *The Tax Magazine*, September 1936, pp. 528-532. (A general survey)

APPENDICES

Appendix A—Account and Budget Forms

1. Skeleton Outline of Small-Municipality Expenditure Classification

1000 *Services—Personal*

- 1100 Salaries and wages, regular
- 1200 Salaries and wages, temporary
- 1300 Other compensations

2000 *Services—Contractual*

- 2100 Communication and transportation
- 2200 Subsistence, care, and support
- 2300 Printing, binding, and advertising
- 2400 Heat, light, power, and water
- 2500 Repairs

3000 *Commodities*

- 3100 Supplies
- 3200 Materials

4000 *Current Charges*

- 4100 Rents
- 4200 Insurance

5000 *Current Obligations*

- 5100 Interest
- 5200 Pensions

6000 *Properties*

- 6100 Equipment
- 6200 Buildings and improvements
- 6300 Land

7000 *Debt Payments*

- 7100 Serial bonds
- 7200 Sinking fund instalments

2. Division Budget Estimate Page (New York City Department of Water Supply, Gas and Electricity)

| Form O | | Page # 2 ✓ | | Title of Account | | General Plant ✓ | | Equipment | | Division | | Investigation, Design and Statistics | |
|--|-----------------|--|--------|---------------------------------|--------|---|--------|-------------------------------|--------|--------------------|--------|--------------------------------------|--------|
| Code 276 | | | | | | | | | | | | | |
| Article | Unit of Measure | Consumption Last 7 months 1936 | | Consumption First 5 months 1937 | | Consumption Last 12 months ending May 31, 1937 | | Consumed During the Year 1936 | | Requested for 1938 | | Requested for First 3 months | |
| | | Units | Cost | Units | Cost | Units | Cost | Units | Cost | Units | Cost | Units | Cost |
| Oct. forward | | | | | | | | | | | | | |
| Seals, 12" triangular, engineer's | each | - | - | 2 | 3.30 | 2 | 3.30 | - | - | 3 | 4.95 | 2 | 3.30 |
| Seals, 12" triangular, architect's | " | - | - | - | - | - | - | - | - | 3 | 4.95 | 2 | 3.30 |
| Tapes, Metallic 80 ft. | " | 2 | 9.38 | 7 | 32.83 | 9 | 42.21 | 6 | 23.38 | 12 | 62.16 | 12 | 62.16 |
| ditto 100 ft. | " | 2 | 13.44 | 9 | 60.48 | 11 | 75.92 | 3 | 18.94 | 8 | 59.36 | 4 | 29.68 |
| ditto 50 (ft.) refills | " | 2 | 3.80 | - | - | 2 | 3.80 | 2 | 3.80 | 6 | 11.40 | 3 | 5.70 |
| ditto 100 ft. refills | " | 2 | 7.42 | - | - | 2 | 7.42 | 2 | 7.42 | 6 | 22.26 | 3 | 11.13 |
| Tapes, Steel 50 | " | 2 | 13.58 | 6 | 40.74 | 8 | 54.32 | 5 | 27.83 | 20 | 135.80 | 6 | 40.74 |
| ditto 100' T squares 42" | " | 2 | 21.94 | - | - | 5 | 54.85 | 3 | 30.44 | 12 | 121.14 | 6 | 65.52 |
| Triangles 6" | " | 2 | 7.00 | - | - | 2 | 7.00 | 2 | 7.00 | 2 | 7.00 | - | - |
| Oct. 5 deg/30-60 deg. | " | - | - | 1 | .16 | 1 | .16 | - | - | 6 | .96 | 3 | .48 |
| ditto 8" 45° | " | - | - | 1 | .14 | 1 | .14 | - | - | 6 | .84 | 3 | .42 |
| ditto 8" 30- | " | - | - | 2 | .50 | 2 | .50 | 1 | .50 | 6 | 3.60 | 3 | 1.80 |
| 60 deg. Shields, erasing | " | - | - | 2 | .35 | 2 | .35 | 1 | .45 | 6 | 2.70 | 3 | 1.35 |
| | " | 6 | .40 | 6 | .32 | 14 | .72 | 8 | .40 | 12 | .64 | 6 | .32 |
| FORWARD | | | 126 37 | | 194.34 | | 320 71 | | 246 10 | | 573 17 | | 292.03 |

This estimate form is used for certain classes of supplies. Estimates for other classes of expenditure are entered on different forms.

4. City Preliminary Budget Page as Prepared by Budget Bureau (New York City)

| 1936—Departmental Estimates No. 14 | | | | | | | | | |
|---|--------------------------------------|--------------|-----------------------|-----------------------------|--------------|-----------------------|--------------|---|--------------------------|
| DEPARTMENT OF WATER SUPPLY, GAS AND ELECTRICITY—Continued | | | | | | | | | |
| BUDGET FOR 1931, MODIFIED AS OF JULY 1, 1937 | | | | DEPARTMENT REQUEST FOR 1938 | | | | PROPOSED CHANGES FROM BUDGET FOR 1937 AS MODIFIED | |
| Code No. | TITLE | Amount | For Transfer Code No. | General Fund | Amount | For Transfer Code No. | General Fund | Amount | Decrease or Increase (*) |
| 2170 | Fuel Supplies | \$750,000 00 | 2170 | (\$198,800) | \$938,800 00 | 2170 | (\$132,000) | \$332,000 00 | \$11,000 00 |
| 2171 | Postage | 11,000 00 | 2171 | | 11,000 00 | 2171 | | 11,000 00 | 90 00 |
| 2172 | Motor Vehicle Supplies | 23,910 00 | 2172 | (24,660) | 24,660 00 | 2172 | (24,000) | 24,000 00 | \$12,000 00 |
| 2173 | Water Treatment Supplies | 90,000 00 | 2173 | (113,837) | 153,837 00 | 2173 | (122,000) | 122,000 00 | 450 00 |
| 2174 | General Plant Supplies | 11,200 00 | 2174 | (113,198) | 11,108 00 | 2174 | (13,850) | 13,850 00 | 450 00 |
| 2175 | Motor Vehicles and Equipment | 6,203 00 | 2175 | (112,463) | 132,663 00 | 2175 | (60,000) | 60,000 00 | \$12,000 00 |
| The sum of \$93,529 in this code is provided for the purchase of motor vehicles. No expenditures for the purchase of motor vehicles shall be made except upon authority approved by the Director of the Budget. | | | | | | | | | |
| 2176 | General Plant Equipment | 46,221 00 | 2176 | (86,105) | 86,105 00 | 2176 | (52,000) | 52,000 00 | \$11,775 00 |
| 2177 | Miscellaneous | 149,000 00 | 2177 | (30,473) | 307,473 00 | 2177 | (189,000) | 189,000 00 | \$40,000 00 |
| 2178 | Motor Vehicle Materials | 6,520 00 | 2178 | (6,591) | 6,591 00 | 2178 | (6,500) | 6,500 00 | 20 00 |
| 2179 | General Repairs | 500 00 | 2179 | | 500 00 | 2179 | | 500 00 | 20 00 |
| 2180 | Water Supply Repairs | 94,130 00 | 2180 | | 143,130 00 | 2180 | | 143,130 00 | \$5,210 00 |
| 2181 | Motor Vehicle Repairs | 6,500 00 | 2181 | | 10,445 00 | 2181 | | 10,445 00 | \$1,440 00 |
| 2182 | Street and Park Lighting | | 2182 | | 2,348,000 00 | 2182 | | 2,348,000 00 | \$1,000 00 |
| 2183 | Buildings and The Bronx | | 2183 | | 1,915,000 00 | 2183 | | 1,915,000 00 | \$9,000 00 |
| 2184 | Queens | | 2184 | | 1,641,000 00 | 2184 | | 1,641,000 00 | \$10,000 00 |
| 2185 | Richmond | | 2185 | | 498,000 00 | 2185 | | 492,000 00 | \$5,000 00 |
| 2186 | Light and Power for City Structures— | | 2186 | | 2,274,000 00 | 2186 | | 2,274,000 00 | \$47,000 00 |
| 2187 | Manhattan and The Bronx | | 2187 | | 930,000 00 | 2187 | | 930,000 00 | \$6,000 00 |
| 2188 | Queens | | 2188 | | 365,000 00 | 2188 | | 365,000 00 | \$6,000 00 |
| 2189 | Richmond | | 2189 | | 141,000 00 | 2189 | | 141,000 00 | \$12,000 00 |
| 2190 | Hunt for Public Buildings— | | 2190 | | 68,000 00 | 2190 | | 68,000 00 | \$1,000 00 |
| 2191 | Manhattan | | 2191 | | 68,000 00 | 2191 | | 68,000 00 | \$1,000 00 |
| 2192 | Queens | | 2192 | | 68,000 00 | 2192 | | 68,000 00 | \$1,000 00 |
| 2193 | Richmond | | 2193 | | 68,000 00 | 2193 | | 68,000 00 | \$1,000 00 |

The departmental estimates are analyzed, possibly revised, and are printed in book form for study by the legislative body.

5. City Final Budget Page (New York City)

231

DEPARTMENT OF WATER SUPPLY, GAS AND ELECTRICITY—*Continued*

| | | |
|--------------------------------------|-----------------------------------|--------------|
| 2176 | General Plant Equipment | 52,000 00 |
| 2177 | Materials | 189,000 00 |
| 2178 | Motor Vehicle Materials | 6,500 00 |
| 2179 | General Repairs | 900 00 |
| 2180 | Water Supply Repairs | 100,000 00 |
| 2181 | Motor Vehicle Repairs | 8,000 00 |
| Street and Park Lighting— | | |
| 2182 | Manhattan and The Bronx | 2,297,000 00 |
| 2183 | Brooklyn | 1,895,000 00 |
| 2184 | Queens | 1,570,000 00 |
| 2185 | Richmond | 492,000 00 |
| Light and Power for City Structures— | | |
| 2186 | Manhattan and The Bronx | 1,950,000 00 |
| 2187 | Brooklyn | 866,000 00 |
| 2188 | Queens | 430,000 00 |
| 2189 | Richmond | 153,000 00 |
| Heat for Public Buildings— | | |
| 2192 | Manhattan | 60,000 00 |

2193 Hire of Horses and Vehicles with Drivers—

| | | |
|--------------------------|--|-------------------|
| Catskill Watershed— | | |
| 1 | Driver with Team and Vehicle or Mower | \$1,200 00 |
| 4 | Driver with Team and Vehicle at \$8 a day (250 days) | 2,000 00 |
| Croton Watershed— | | |
| 10 | Driver with Team and Vehicle at \$8 a day (517 days) | 4,136 00 |
| Brooklyn Watershed— | | |
| 13 | Driver with Team and Vehicle at \$7 a day (303 days) | 2,121 00 |
| Schedule Total | | <u>\$9,457 00</u> |

| | | |
|------|---|--------------|
| 2194 | Carfare and Traveling Expenses | \$25,000 00 |
| 2195 | Telephone Service | 30,000 00 |
| 2196 | General Plant Service | 15,800 00 |
| 2197 | Rental of Fire Hydrants | 208,000 00 |
| 2198 | Contingencies | 480 00 |
| 2199 | Taxes | 1,350,000 00 |
| 2200 | Printing, Stationery, Supplies, Etc | 18,000 00 |

Total Other Than Personal Service \$12,346,987 00

Departmental Summary—

| | |
|---|-----------------------|
| Total Personal Service | <u>\$6,158,642 00</u> |
| Tax Levy Allowance | \$5,656,262 00 |
| Corporate Stock Allowance, Special and Trust Fund Allowance | 502,380 00 |

Total Other Than Personal Service \$12,346,987 00

Departmental Total \$18,505,629 00

Tax Levy Allowance \$18,003,249 00

Corporate Stock Allowance, Special and Trust Fund Allowance 502,380 00

DEPARTMENT OF SANITATION

Personal Service—

Salaries Regular Employees—

Division of Administration—

2300 Executive—

| | | |
|---|---|-------------|
| 1 | Commissioner of Sanitation | \$10,000 00 |
| 2 | Deputy Commissioner of Sanitation | 7,250 00 |
| 3 | Deputy Commissioner of Sanitation | 12,000 00 |

2 at \$6,000

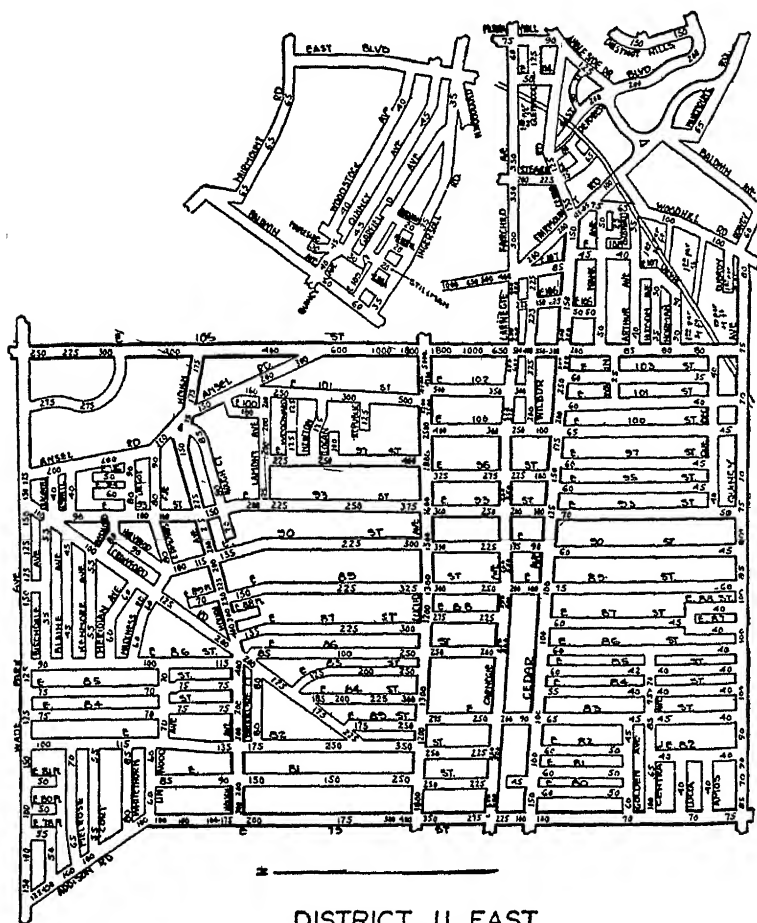
After the legislative body passes the budget, with or without revision of the Budget Bureau's allowances, the entire budget is reprinted as part of the legislative procedure and for the use of the departments and the public.

Appendix B—Property Tax Forms

1. Filing Card Recommended by the Minnesota Tax Commission for Detailed Record of Information on Rural Land and Improvements

| Unplatted Real Property Assessment, 1940 | | | | Township of Wilson | | County of Clover, Minn. | |
|---|------------------|--|----------|--------------------|-----------|-------------------------|-----------|
| Name of Owner | Sec. 1 | Twp. 30 | Range 20 | Level | Rolling | Acres 80 | Acres 80 |
| Description | Sec. 1 | Loam | Sandy | Per Acre. | Per Acre. | Value | Value |
| Acres Tillable 140 CHARACTER OF LAND: Clay <input checked="" type="checkbox"/> Loam <input checked="" type="checkbox"/> Sandy <input type="checkbox"/> Stony <input type="checkbox"/> KIND AND VALUE OF LANDS—Cultivated. | | | | | | | |
| Meadow | 30 | Acres at | .. \$90 | Per Acre. | Value | \$ 9,000 | Hilly |
| Pasture | 25 | Acres at | .. \$75 | Per Acre. | Value | \$ 2,250 | |
| Swamp | | Acres at | .. \$60 | Per Acre. | Value | \$ 1,500 | |
| Timber | | Acres at | .. | Per Acre. | Value | \$ | |
| Cut-over | | Acres at | .. | Per Acre. | Value | \$ | |
| Waste | 5 | Acres at | .. \$10 | Per Acre. | Value | \$ 50 | |
| | | True and Full Value Land | .. | Per Acre. | Value | \$ 12,800 | |
| STRUCTURES: DWELLING: CONSTRUCTION: Frame, <input checked="" type="checkbox"/> Brick, <input type="checkbox"/> Stone, <input type="checkbox"/> Stucco. BASEMENT: Full, <input checked="" type="checkbox"/> Half, <input type="checkbox"/> None. ROOF: Wood Shingles, <input checked="" type="checkbox"/> Asbestos, <input type="checkbox"/> Composition. HEAT: Hot Air, <input checked="" type="checkbox"/> Hot Water, <input type="checkbox"/> Stoves. Number of Rooms 7 Stories 2 | | | | | | | |
| Barn: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 1,800 | |
| Granary: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 1,000 | |
| Garage: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 150 | |
| Machine Sheds: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 100 | |
| Hog House: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 100 | |
| Silo: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ 200 | |
| Windmill: | CONDITION: Good, | Fair, <input checked="" type="checkbox"/> Poor | | | Value | \$ | |
| Other Structures: | | | | | Value | \$ | |
| Machinery permanently attached to real estate | | | | | Value | \$ 50 | |
| True and Full Value Lands | | | | | | | \$ 3,400 |
| True and Full Value Structures, including attached machinery. | | | | | | | \$ 12,800 |
| True and Full Value Land and Structures, including attached machinery. | | | | | | | \$ 3,400 |
| Assessed Value | | | | | | | \$ 16,200 |
| | | | | | | | \$ 5,400 |

2. "Block and Lot" Map

DISTRICT II EAST
CLEVELAND OHIO

| CORNER LOT PERCENTAGE TABLE | | | | | | | |
|---|------|------|------|------|------|------|------|
| FOR DEPTH OF SIDE STREET WHICH IS THE FRONTAGE ON THE MAIN STREET | | | | | | | |
| FEET | % | FEET | % | FEET | % | FEET | % |
| 5 | 15.0 | 30 | 51.0 | 55 | 64.5 | 80 | 75.0 |
| 10 | 25.0 | 35 | 55.0 | 60 | 64.0 | 85 | 74.5 |
| 15 | 33.0 | 40 | 58.0 | 65 | 67.0 | 90 | 71.0 |
| 20 | 41.0 | 45 | 60.7 | 70 | 68.0 | 95 | 71.5 |
| 25 | 49.0 | 50 | 63.0 | 75 | 69.0 | 100 | 72.0 |

| DEPTH TABLE | | | | | | | |
|-------------|-------|-------|-------|--------|--------|--------|--------|
| DEPTH | % | DEPTH | % | DEPTH | % | DEPTH | % |
| 5 FT | 14.35 | 55 FT | 76.20 | 105 FT | 102.00 | 155 FT | 116.80 |
| 10 | 23.00 | 60 | 79.00 | 110 | 104.00 | 160 | 116.80 |
| 15 | 33.22 | 65 | 82.61 | 115 | 105.78 | 165 | 117.64 |
| 20 | 41.00 | 70 | 85.68 | 120 | 107.50 | 170 | 118.40 |
| 25 | 47.90 | 75 | 88.30 | 125 | 109.15 | 175 | 119.16 |
| 30 | 54.00 | 80 | 90.50 | 130 | 110.50 | 180 | 119.80 |
| 35 | 59.20 | 85 | 92.33 | 135 | 111.80 | 185 | 120.43 |
| 40 | 64.00 | 90 | 93.80 | 140 | 113.00 | 190 | 121.00 |
| 45 | 68.45 | 95 | 95.05 | 145 | 114.05 | 195 | 121.53 |
| 50 | 72.50 | 100 | 96.00 | 150 | 115.00 | 200 | 122.00 |

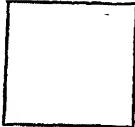
3. Filing Card Used (Duluth, Minn.) for Recording Information on Assessment of
Urban Sites and Buildings

| | | | | | | | | | | | | |
|-------------------------------------|------|--------|-------|--------|-------|---------|------|-------|-------|------|-------|-------|
| DIVISION OR ADDITION | | LOT NO | | BLK NO | | FILE NO | | | | | | |
| OWNER | | | | | | | | | | | | |
| ASSESSMENTS | | | | | | | | | | | | |
| ASS'D BY C B Co. B T. C | 1932 | | | 1934 | | | 1936 | | | 1938 | | |
| | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| ASS'D BY C B Co. B T. C | 1940 | | | 1942 | | | 1944 | | | 1946 | | |
| | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| ASS'D BY C B Co. B T. C | 1948 | | | 1950 | | | 1952 | | | 1954 | | |
| | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL | LAND | BLDGS | TOTAL |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| | | | | | | | | | | | | |
| MEMO. | | | | | | | | | | | | |

3 (continued). Filing Card Used (Duluth, Minn.) for Recording Information on Assessment of Urban Sites and Buildings.

[illegible]

3 (concluded). Filing Card Used (Cleveland, Ohio) for Recording Information on Assessment of Urban Sites and Residences

| | | | | | | | | | | | |
|--|------------|-------|---------------|--------|---|-----------------------------|------------------|-----------------|-------------------------|-------------|--------|
| Tax District _____ Vol. _____ Page _____ | | | | | Testing District _____ Card No. _____ | | | | | | |
| Owner _____ S. L. _____ | | | | | Dist. _____ Map _____ Block _____ | | | | | | |
| Number _____ St. _____ | | | | | Book No. _____ Page _____ Line _____ | | | | | | |
| Kind of Building _____ | | | | | Listed for taxes in name of _____ | | | | | | |
| Schedule _____ Class _____ Base Factor _____ Add or Deduct For Area _____ | | | | | 19 _____ | | | | | | |
| Stories | Dimensions | Area | Actual Factor | Totals | Sub | Orig. Lot _____ | | | | | |
| _____ | _____ | _____ | _____ | _____ | Sub Lot | _____ | | | | | |
| _____ | _____ | _____ | _____ | _____ | Feet Front | Street _____ | | | | | |
| _____ | _____ | _____ | _____ | _____ | Depth | Acres _____ House No. _____ | | | | | |
| _____ | _____ | _____ | _____ | _____ | Assessments | 193 | 193 | 193 | | | |
| Description of Building Foundation _____ Ext. Walls _____ Roof _____ Dormers _____ Bays _____ Outside Chimney _____ Porches _____ Basement _____ Attic _____ Plumbing _____ Heating _____ Finish _____ Cabinets _____ Mantels _____ Tile Floors _____ Total Additions and Deductions _____ | | | | | Land | _____ | _____ | _____ | _____ | | |
| | | | | | Bldg. | _____ | _____ | _____ | _____ | | |
| | | | | | Totals | _____ | _____ | _____ | _____ | | |
| Instructions: Sketch odd shaped lots. Use square for others. Always place north end of lot toward top of card. Show unit values outside and lot measurements inside lot lines. Indicate corner influence and alley widths. | | | | |  | | | | | | |
| Net Addition or Deduction _____ | | | | | | | | | | | |
| REPRODUCTION VALUE Age _____ Yrs. Depreciation _____ % NET VALUE _____ Car Garage _____ Walls _____ Roof _____ Floor _____ Value _____ TOTAL BLDG. VALUE _____ | | | | | Feet Front | Feet Deep | % of Actual Unit | % for Tri angle | % of L. Less Than \$300 | Actual Unit | Totals |
| Remarks _____ Original Record _____ Appraised _____ 192 _____ Wm. No. _____ Year _____ By _____ | | | | | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| | | | | | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| | | | | | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| | | | | | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| | | | | | _____ | _____ | _____ | _____ | _____ | _____ | _____ |
| Written by _____ Valued by _____ Checked by _____ | | | | | | | | | | | |

4. Form of Town Tax Roll

| FIRST COLUMN | | SECOND COLUMN | | | THIRD COLUMN | | | FOURTH COLUMN | |
|--------------------------------------|---|--|--|---|--|---|--|--|-----------|
| | | LOCATION OF PROPERTY | | | DESCRIPTION | | | QUANTITY | |
| Item 1 | Name of Owner (Last Known or Reputed) | 2 | 3 | 4 | 5 | 6 | 7 | 8 | 9 |
| | No of School District | Name of Village where property is located | Name of Special District where property is located | Location Street or Road | Side of Street or Road | Insert in this Column the names of the Abutting Property Owners on each of our sides Respectively. E—Jones, S—N—Brown, E—Jones, S—Smith, W—Robinson | Character of Property State whether forest mining agricultural or other vacant lots railroad and other utilities | Property of State or Line Dimensions | Amount of |
| FIFTH COLUMN | | | | | | | | | |
| ASSESSMENTS | | | | | | | | | |
| Item 10 | Full Value of Land Exclusive of Buildings thereon | 11 | 12 | 13 | 14 | 15 | 16 | 17 | |
| | Full Value of Real Property Including Buildings thereon | Am't of Exemption of Property Exempt wholly or should be entered in Part V | Full Value of Real Property Less amount of exemptions if any | Taxable Value of Real Property within the Village of | Taxable Value of Real Property within the District | Taxable Value of Real Property within the District | Taxable Value of Real Property within the District | Unimproved Property Taxes Pursuant to Section 34 | |
| SIXTH COLUMN | | | | | | | | | |
| AMOUNT AND PURPOSES OF GENERAL TAXES | | | | | | | | | |
| 18 | 19 | 20 | 21 | 22 | 23 | SPECIAL TAXES | | | |
| Armory and Court Expense Tax | County Tax | Town Including General Highway Taxes | Highway Tax Outside Incorporated Villages | Total County and Town Taxes Including Highway, Armory and Court Expense Tax | District Tax | Taxes Total | | | |

5. Corporate Excess Tax Return

.....County Ward NoDistrict No.....

TAX SCHEDULE "C"

**CORPORATIONS, PERSONS, COPARTNERSHIPS, AND JOINT STOCK COMPANIES ENGAGED IN
THE MANUFACTURE OF GOODS, WARES, MERCHANDISE.**

(Sections 23 and 24, Chapter 435, Acts of 1899)

PART I

(To be filled out by the Individual or Company's Official.) Fill All Blanks.

NameAddress

State whether a Corporation, Copartnership, or Individual

Amount of capital stock issued or Capital Invested, \$.....

Surplus and undivided profit, \$.....

What is the market value per share? \$.....

What is the actual value per share? \$.....

What dividends have been paid on stock in the last two years?per cent per annum

Amount invested in real estate and buildings? \$.....

Present assessed value of the same?

Amount invested in machinery tools, equipment, etc., \$.....

Present actual value of the same? \$.....

Actual value of manufactured articles on hand on January 10th, \$.....

EXPLANATORY NOTE—The taxpayer should take note that manufactured articles are exempt only so long as they remain the property of the manufacturer. When manufactured articles pass from the hands of the manufacturer they are no longer exempt from taxation.

Actual value of materials and supplies on hand January 10th which represented products
of the soil which you produced yourself or purchased direct from the producer?\$.....

Actual value of other materials and supplies on hand on January 10th bought on the open
market from others than the producer?\$.....

EXPLANATORY NOTE—Raw materials in the hands of the manufacturer are not exempt unless such raw materials were produced from the soil by the manufacturer or purchased by the manufacturer direct from the producer. Raw materials purchased in the open market from others than the producers are not exempt.

REAL ESTATE AND PERSONALTY OWNED

Each tract of real estate must be shown separately. Attach lists of personalty owned in each County separately

| LOCATION COUNTY | DIST NO. | WARD NO. | NO ACRES OR LOTS | ACTUAL VALUE LAND AND IMPROVEMENTS | ACTUAL VALUE PERSONALTY | FOR USE OF TAX ASSESSOR |
|-----------------|----------|----------|------------------|------------------------------------|-------------------------|-------------------------|
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |
| | | | | | | |

(See Section 412.)

5 (concluded). Corporate Excess Tax Return

Condensed Balance Sheet as of _____, 193...

| DEBITS AND ASSETS | Book Value | Actual Value | For the use of the Tax Assessor |
|---------------------|------------|--------------|---------------------------------|
| Real Estate | \$ | \$ | |
| Machinery | | | |
| Securities | | | |
| Cash | | | |
| Notes Receivable | | | |
| Accounts Receivable | | | |
| Inventory | | | |
| Other Assets—List | | | |
| Deferred Charges | | | |
| TOTALS | | | |

| CREDITS AND LIABILITIES | Book Value | Actual Value | |
|-------------------------|------------|--------------|--|
| Bonded Debt | \$ | \$ | |
| Mortgages | | | |
| Accounts Payable | | | |
| Notes Payable | | | |
| Reserves | | | |
| Depreciation | | | |
| Other Liabilities—List | | | |
| Deferred Credits | | | |
| Capital Stock, Pref \$ | | | |
| Common | | | |
| Surplus | | | |
| Profit and Loss | | | |
| TOTALS | | | |

STATE OF TENNESSEE

County of _____ }

We, _____, President and _____ Secretary and Treasurer, of the above-named concern, do hereby solemnly swear that we have made true and correct answers to all the above questions and that we have honestly and truthfully stated the condition of the business, as of the date named, and that we have given the actual cash value of all property as of said date, both tangible and intangible, and that all attached statements, inventories, balance sheets and exhibits are true and correct.

Sworn to and subscribed before me _____

this the _____ day of _____ 193...

(SEAL)

Appendix C—Personal Income Tax Forms

1. Federal Information Return

Form 1096
TREASURY DEPARTMENT
INTERNAL REVENUE SERVICE

UNITED STATES INFORMATION RETURN FOR CALENDAR YEAR 1940

INSTRUCTIONS TO PAYORS

Prepare one of these forms for each payee in accordance with the instructions on return Form 1096

Do not include payments to non-resident aliens reported on Form 1042
Forward with return Form 1096 so as to reach the Commissioner of Internal Revenue, Returns Distribution Section, Washington, D. C., on or before February 15, 1941

Copy of this form as filed with the Government should be furnished to the employee whose income is reported in first column to assist him in preparing his income tax return.

TO
WHOM
PAID

(Full name and home address) (If employee is a married woman, name of husband should also be furnished)

KIND AND AMOUNT OF INCOME PAID

| SALARIES, WAGES, FEES, COMMISSIONS, BONUSES (If single \$800 or more, if married \$2,000 or more) | INTEREST ON NOTES, MORTGAGES, ETC (\$800 or more aggregate amount of above items) | RENTS AND ROYALTIES | OTHER FIXED OR DETERMINABLE INCOME | FOREIGN ITEMS (\$800 or more) | DIVIDENDS (\$100 or more) |
|--|---|------------------------|--|----------------------------------|------------------------------|
| \$ | \$ | \$ | \$ | \$ | \$ |
| <input type="checkbox"/> SINGLE <input type="checkbox"/> MARRIED | | | | | |

o16-30162

BY
WHOM
PAID
(Name and
address)

(OVER)

2. Federal Tax Return—Short Form

| FORM 1040 A <small>TREASURY DEPARTMENT Internal Revenue Service</small> <small>(Auditor's Stamp)</small> | | UNITED STATES INDIVIDUAL INCOME AND DEFENSE TAX RETURN FOR GROSS INCOMES OF NOT MORE THAN \$5,000 DERIVED FROM SALARIES, WAGES, DIVIDENDS, INTEREST, AND ANNUITIES <small>(NOTE.—If you are engaged in a profession or business (including farming), or are a member of a partnership, or had income or losses from the renting or sale of property, use Form 1040)</small> <small>To be filed with the Collector of Internal Revenue for your District on or before March 15, 1941</small> PRINT NAME AND HOME OR RESIDENTIAL ADDRESS PLAINLY BELOW | | 1940 <small>Do not write in these spaces</small> Serial No. _____ Amount Paid, \$ _____ (Cashier's Stamp) Cash—Check—M. O. _____ |
|---|--------------------|---|---------------|--|
| JOHN ADAMS and MARGARET ADAMS <small>(Name) (Use given names of both husband and wife, if this is a joint return)</small> 4862 West 215th Street <small>(Street and number, or rural route)</small> New York New York New York <small>(Post office) (County) (State)</small> | | | | |
| QUESTIONS | | | | |
| 1. What is your occupation? <u>Salesman</u> 2. Check whether you are a citizen <input checked="" type="checkbox"/> or a resident alien <input type="checkbox"/> 3. Did you file a return for any prior year? <u>Yes</u> If so, what was the latest year? <u>1939</u> To which Collector's office was it sent? <u>3rd District, New York</u> | | 4. Are items of income or deductions of both husband and wife included in this return? <u>Yes</u> 5. State name of husband or wife if a separate return was made, personal exemption, if any, claimed thereon, and the Collector's office to which it was sent. | | |
| INCOME | | | | |
| 1. Salaries and other compensation for personal services. (From Schedule A) | \$ 3,850 00 | \$ 4,402 60 | | |
| 2. Dividends | 75 00 | | | |
| 3. Interest on bank deposits, notes, mortgages, etc. | 62 60 | | | |
| 4. Interest on corporation bonds | 190 00 | | | |
| 5. Other income (including income from annuities, fiduciaries, etc.). (From Schedule B) | 225 00 | | | |
| 6. Total income in items 1 to 5 | \$ 4,402 60 | | | |
| DEDUCTIONS | | | | |
| 7. Contributions paid. (From Schedule C) | \$ 25 00 | 680 50 | | |
| 8. Interest paid. (From Schedule D) | 185 00 | | | |
| 9. Taxes paid. (From Schedule E) | 165 50 | | | |
| 10. Other deductions authorized by law (From Schedule F) | 305 00 | | | |
| 11. Total deductions in items 7 to 10 | 680 50 | | | |
| COMPUTATION OF TAX | | | | |
| 12. Net income (item 6 minus item 11) | | \$ 3,722 10 | | |
| 13. Less. Earned income credit, either (a) or (b) (See Instruction 13) | | | | |
| (a) If item 12 is \$3,000 or less, enter 10% of such item | | \$ | 372 21 | |
| (b) If item 12 is more than \$3,000, enter 10% of item 1 or 10% of item 12, whichever is smaller, but not less than \$300 | | 372 21 | | |
| 14. Personal exemption. (From Schedule H-1) | 2,000 00 | 2,472 21 | | |
| 15. Credit for dependents. (From Schedule H-2) | 100 00 | | | |
| 16. Balance of net income taxable (item 12 minus items 13, 14, and 15) | | \$ 1,249 89 | | |
| 17. Income tax (4% of item 16) | | \$ 50 00 | | |
| 18. Less. Income tax paid at source on tax-free covenant bonds | | \$ 80 | 80 | |
| 19. Income tax paid to a foreign country or United States possession. (Attach Form 1116) | | - | | |
| 20. Balance of income tax (item 17 minus items 18 and 19) | | \$ 49 20 | | |
| 21. Defense tax (10% of item 17) | | 5 00 | | |
| 22. Total income and defense taxes due (item 20 plus item 21). (See Instruction E as to payment of tax) | | \$ 54 20 | | |
| NOTE.—In order that this return may be accepted as meeting the requirements of the Internal Revenue Code, the data called for herein must be set forth FULLY and CLEARLY. | | | | |

3. Federal Tax Return—Long Form

FORM 1040
Treasury Department
Internal Revenue Service

UNITED STATES
INDIVIDUAL INCOME AND DEFENSE TAX RETURN

Page 1
1940

(Auditor's Stamp)

FOR GROSS INCOMES OF MORE THAN \$5,000 FROM SALARIES, WAGES,
DIVIDENDS, INTEREST, ANNUITIES, AND FOR INCOMES FROM
OTHER SOURCES REGARDLESS OF AMOUNTS

For Calendar Year 1940

or fiscal year beginning _____, 1940, and ended _____, 1941

To be filed with the Collector of Internal Revenue for your district not later than the 15th day of the third month following the close of your taxable year

PRINT NAME AND ADDRESS PLAINLY. (See Instruction C)

_____ **HENRY BLACK** _____
(Name) (Use given names of both husband and wife, if this is a joint return)

_____ **7240 East 64th Street** _____
(Street and number, or rural route)

_____ **New York** _____ **New York** _____ **New York** _____
(Post office) (County) (State)

(Do not use these spaces)

File
Code
Serial
No.

District
(Cashier's Stamp)

Cash—Check—M. O.
First Payment

| Item and Instruction No. | INCOME | | | |
|--------------------------|--|--|-----------|----|
| 1 | Salaries and other compensation for personal services (From Schedule A) | | \$ 600 | 00 |
| 2 | Dividends | | 3,050 | 00 |
| 3 | Interest on bank deposits, notes, mortgages, etc. | | 245 | 50 |
| 4 | Interest on corporation bonds | | 1,450 | 00 |
| 5 | Taxable interest on Government obligations, etc. (From Schedule B) | | 940 | 00 |
| 6 | Income (or loss) from partnerships, syndicates, pools, etc. (other than capital gains or losses) (Furnish names and addresses): | | | |
| | <u>Black & White, New York, N. Y.</u> | | 2,830 | 74 |
| 7 | Income from fiduciaries. (Furnish names and addresses): | | | |
| | <u>Estate of William Black, New York, N. Y.</u> | | 3,520 | 46 |
| 8 | Rents and royalties. (From Schedule C) | | 8,357 | 10 |
| 9 | Income (or loss) from business or profession. (From Schedule D) | | 44,133 | 19 |
| 10 | (a) Net short-term gain from sale or exchange of capital assets (From Schedule F) | | None | |
| | (b) Net long-term gain (or loss) from sale or exchange of capital assets (From Schedule F) | | 10,048 | 00 |
| | (c) Net gain (or loss) from sale or exchange of property other than capital assets. (From Schedule G) | | (12,250) | 00 |
| 11 | Other income (including income from annuities). (State nature) | | 6,550 | 00 |
| 12 | Total income in items 1 to 11. (Enter nontaxable income in Schedule I) | | \$ 69,474 | 99 |
| | DEDUCTIONS | | | |
| 13 | Contributions paid. (Explain in Schedule H) | | 1,500 | 00 |
| 14 | Interest. (Explain in Schedule H) | | 1,085 | 00 |
| 15 | Taxes. (Explain in Schedule H) | | 7,048 | 94 |
| 16 | Losses from fire, storm, shipwreck, or other casualty, or theft. (Explain in Schedule H) | | 1,900 | 00 |
| 17 | Bad debts. (Explain in Schedule H) | | 9,100 | 00 |
| 18 | Other deductions authorized by law. (Explain in Schedule H) | | 7,300 | 00 |
| 19 | Total deductions in items 13 to 18 | | 27,833 | 94 |
| 20 | Net income (item 12 minus item 19) | | \$ 41,641 | 05 |

COMPUTATION OF TAX

| | | | | | | | |
|----|---|-----------|----|----|---|----------|----|
| 21 | Net income (item 20 above) | \$ 41,641 | 05 | 28 | Normal tax (4% of item 27) | \$ 1,471 | 92 |
| 22 | Less: Personal exemption. (From Schedule J-1) | \$ 2,000 | 00 | 29 | Surtax on item 24 (See Instruction 29) | 7,522 | 78 |
| 23 | Credit for dependents. (From Schedule J-2) | 800 | 00 | 30 | Total (item 28 plus item 29) | 8,994 | 70 |
| 24 | Balance (surplus net income) | \$ 38,841 | 05 | 31 | Total income tax (item 30, or if you had a net long-term capital gain or loss, enter line 16, Schedule F) | 8,362 | 32 |
| 25 | Less: Interest on Government obligations, etc. (See Instruction 25) | \$ 1,040 | 00 | 32 | Less: Income tax paid at source | 10 | 00 |
| 26 | Earned income credit. (From Schedule K-1 or K-2) | 1,003 | 08 | 33 | Income tax paid to a foreign country or U. S. possession. (Attach Form 1116) | 10 | 00 |
| 27 | Balance subject to normal tax | \$ 36,797 | 97 | 34 | Balance of income tax (item 31 minus item 32 and 33) | 8,352 | 32 |
| | | | | 35 | Defense tax (10% of item 31) (See Instruction 35) | 836 | 43 |
| | | | | 36 | Total income and defense taxes due (item 34 plus item 35) | 9,188 | 55 |

NOTE.—In order that this return may be accepted as meeting the requirements of the Internal Revenue Code, the data called for herein must be set forth FULLY and CLEARLY

3 (continued). Federal Tax Return—Long Form

Schedule A.—INCOME RECEIVED FROM OTHERS CONSISTING OF SALARIES, WAGES, FEES, COMMISSIONS, BONUSES, AND OTHER COMPENSATION FOR PERSONAL SERVICES (See Instruction 1)

| 1. Name and address of employer—If a governmental unit, indicate whether "Federal," "State," or "Local" | 2. Amount | 3. Expenses (itemize) | 4. Amount |
|---|-----------|-----------------------|-----------|
| A. Co., New York, N. Y. | \$ 510 00 | | |
| B. Co., Rochester, N. Y. | 50 00 | R. R. fare and meals | 20 00 |
| Supreme Court, N. Y. | 60 00 | | |
| Total of column 2 minus total of column 4 (enter as item 1, page 1) | | | \$ 600 00 |

Schedule B.—INTEREST ON GOVERNMENT OBLIGATIONS, ETC (See Instruction G)

| 1. Obligations or securities | 2. Amount owned at end of year including your proportionate share of such obligations held by estates, trusts, partnerships, or common trust funds | 3. Interest received or accrued during the year | 4. Amount of principal, interest, or which is exempt from taxation | 5. Interest on amount in excess of exemption |
|---|--|---|--|--|
| (a) Obligations of a State, Territory or political subdivision thereof, or the District of Columbia, or United States possessions | \$ 5,000 00 | \$ 200 00 | All | xxxxxx xx |
| (b) Obligations issued under Federal Farm Loan Act, or under such Act as amended | 2,000 00 | 85 00 | All | xxxxxx xx |
| (c) Obligations of United States issued on or before September 1, 1917 | 3,000 00 | 90 00 | All | xxxxxx xx |
| (d) Treasury Notes, Treasury Bills, and Treasury Certificates of Indebtedness | 4,000 00 | 60 00 | All | xxxxxx xx |
| (e) United States Savings Bonds and Treasury Bonds | 24,000 00 | 840 00 | \$5,000 | \$ 640 00 |
| (f) Obligations of instrumentalities of the United States (other than obligations to be reported in (d) above) | 10,000 00 | 300 00 | None | 300 00 |
| (g) Total (enter as item 5, page 1) | | | | \$ 940 00 |

Schedule C.—INCOME FROM RENTS AND ROYALTIES (See Instruction 8)

| 1. Kind of property | 2. Amount | 3. Depreciation (explain in Schedule E) | 4. Repairs (explain below) | 5. Other expenses (explain below) | 6. Net profit (column 2 minus sum of columns 3, 4, and 5) (enter as item 6, page 1) |
|---------------------|--------------|---|----------------------------|-----------------------------------|---|
| Apartment house | \$ 22,915 00 | \$ 4,500 00 | \$ 2,200 50 | \$ 7,857 40 | \$ 8,357 10 |

Explanation of deductions claimed in columns 4 and 5: Depreciation—\$4,500.00 Heating—\$2,175.40 Insurance—\$600.00

Schedule D.—PROFIT (OR LOSS) FROM BUSINESS OR PROFESSION (See Instruction 9)

(State (1) nature of business Manufacturing, (2) number of places of business ONE, (3) business name and address if different from name and address on page 1 Black & Co., 4430 West 38th St., New York, N. Y.)

| 1. Total receipts | | OTHER BUSINESS DEDUCTIONS | |
|---|---------------|--|--------------|
| | | 11. Salaries and wages not included as "Labor" (do not deduct compensation for yourself) | \$ 13,520 00 |
| COST OF GOODS SOLD | | 12. Interest on business indebtedness | 500 00 |
| (To be used where inventories are an income-determining factor) | | 13. Taxes on business and business property | 5,468 00 |
| 2. Inventory at beginning of year <u>C or M</u> | \$ 25,984 70 | 14. Losses (explain below) | 1,020 00 |
| 3. Merchandise bought for sale | 161,182 33 | 15. Bad debts arising from sales or services | 924 00 |
| 4. Labor | 85,180 00 | 16. Depreciation, obsolescence, and depletion (explain in Schedule E) | 1,600 00 |
| 5. Material and supplies | 7,635 50 | 17. Rent, repairs, and other expenses (itemize below or on separate sheet) | 6,319 55 |
| 6. Other costs (itemize below) | 1,775 00 | 18. Total of lines 11 to 17 | \$ 29,752 10 |
| 7. Total of lines 2 to 6 | \$ 281,787 56 | 19. Net profit (or loss) (line 1 minus lines 9 and 18) (enter as item 9, page 1) | \$ 44,135 19 |
| 8. Less inventory at end of year <u>C or M</u> | 38,705 00 | | |
| 9. Net cost of goods sold (line 7 minus line 8) | \$ 243,082 56 | | |
| 10. Gross profit (line 1 minus line 9) | \$ 73,835 74 | | |

If the production, manufacture, purchase and sale of merchandise is an income-producing factor, inventories are required. Enter "C," or "C or M," on lines 2 and 8 to indicate whether inventories are valued at cost, or cost or market, whichever is lower.

Explanation of deductions claimed in lines 6, 14, and 17: See schedules attached

Schedule E.—EXPLANATION OF DEDUCTION FOR DEPRECIATION CLAIMED IN SCHEDULES C, D, F, AND G

| 1. Kind of property (If buildings, state material of which constructed) | 2. Date acquired | 3. Cost or other basis (Do not include land or other nondepreciable property) | 4. Assets fully depreciated as used at end of year | 5. Depreciation allowed (or allowable) in prior years | 6. Remaining cost or other basis to be recovered | 7. Estimated life used in accumulating depreciation | 8. Estimated remaining life from beginning of year | 9. Depreciation allowable this year |
|---|------------------|---|--|---|--|---|--|-------------------------------------|
| Brick apartment | 3-1-16 | 380,000 00 | None | 107,250 00 | 72,750 00 | 18-40 | 16-1/2 | \$ 4,500 00 |
| Furniture & fixtures | 1-2-35 | 2,000 00 | None | 1,000 00 | 1,000 00 | 10 | 5 | 200 00 |
| Auto truck | C-30-38 | 1,600 00 | None | 600 00 | 1,000 00 | 4 | 2-1/2 | 400 00 |
| Machinery | 1-2-35 | 15,000 00 | None | 5,000 00 | 10,000 00 | 15 | 10 | 1,000 00 |

3 (continued). Federal Tax Return—Long Form

Schedule F—GAINS AND LOSSES FROM SALES OR EXCHANGES OF CAPITAL ASSETS (See Instruction 10)

Page 3

| 1 Kind of property (if necessary attach statement of descriptive details not shown below) | 2 Date acquired Mo. Day Year | 3 Date sold Mo. Day Year | 4 Gross sales price (contract price) | 5 Cost or other basis | 6 Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913 | 7 Depreciation allowed (or allowable) since acquisition or March 1, 1913 (Capitalize in Schedule E) | 8 Gain or loss (column 4 plus column 6 minus the sum of columns 5 and 7) | 9 Per cent | 10 Amount |
|---|---------------------------------|-----------------------------|--------------------------------------|-----------------------|---|---|--|------------|----------------|
| SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD NOT MORE THAN 18 MONTHS | | | | | | | | | |
| (a) M. Co. stock | 11-2-39 | 12-16-40 | \$28,000 00 | \$18,500 00 | \$ 87 50 | \$ — | \$ 9,412 50 | 100 | \$9,412 50 (G) |
| (b) Y Co. stock | 6-15-39 | 10-17-40 | 9,000 00 | 7,500 00 | — | — | 1,500 00 | 100 | 1,500 00 (G) |
| (c) Q Co. stock | 2-1-39 | 9-7-40 | 6,000 00 | 10,000 00 | 50 00 | — | 4,050 00 (L) | 100 | 4,050 00 (L) |
| (d) Real estate | 4-7-39 | 3-8-40 | 30,000 00 | 35,000 00 | — | — | 5,000 00 | 100 | 5,000 00 (L) |
| Total net short term capital gain or loss (enter in line 1, column 3 of summary below) | | | | | | | Gain | | \$1,862 50 |

| | | | | | | | | | |
|---|---------|----------|---|-------------|----------|------|-------------|-----|----------------|
| LONG TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 18 MONTHS BUT NOT FOR MORE THAN 24 MONTHS | | | | | | | | | |
| (a) P Co. stock | 7-6-39 | 11-29-40 | \$12,050 00 | \$3,000 00 | \$ 50 00 | \$ — | \$ 9,000 00 | 66% | \$6,000 00 (G) |
| (b) Q Co. stock | 11-8-39 | 9-1-40 | 3,109 00 | 4,000 00 | 27 00 | — | 918 00 | 66% | 612 00 (L) |
| (c) W Pfd. stock | 10-1-39 | 8-15-40 | 1,500 00 | 2,000 00 | 10 00 | — | 510 00 | 66% | 340 00 (L) |
| (d) R Co. stock | 7-1-38 | 5-1-40 | 340 00 | 3,900 00 | 40 00 | — | 3,600 00 | 66% | 2,400 00 (L) |
| LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 24 MONTHS | | | | | | | | | |
| (a) Real estate | 7-1-35 | 5-2-40 | \$60,000 00 | \$60,000 00 | \$ — | \$ — | \$10,000 00 | 50 | 5,000 00 (G) |
| (b) S Co. bonds | 1-1-28 | 12-31-40 | None | 6,000 00 | — | — | 6,000 00 | 50 | 3,000 00 (L) |
| (c) T Co. stock | 2-4-27 | 10-9-40 | 7,040 00 | 4,200 00 | 40 00 | — | 2,800 00 | 50 | 1,400 00 (G) |
| (d) Real estate | 7-5-32 | 6-1-39 | Installment Sale, Sec statement attached. | — | — | — | 8,000 00 | 50 | 4,000 00 (G) |
| Total net long term capital gain or loss (enter in line 2, column 3 of summary below) | | | | | | | Gain | | \$10,048 00 |

SUMMARY OF CAPITAL NET GAINS OR LOSSES

| 1. Classification | 2. Net short-term capital loss of preceding taxable year (net income for each year) | 3. Net gain or loss to be taken into account from column 19 above | | 4. Net gain or loss to be taken into account from partnerships and common trust funds | | 5. Total net gain or loss to be taken into account in columns 2, 3, and 4 of this summary | |
|--|---|---|------|---|------|---|--|
| | | Gain | Loss | Gain | Loss | Gain | Loss |
| 1. Total net short-term capital gain or loss (enter as item 10 (a) page 1, amount of gain shown in column 5) | \$2,540 00 | \$1,862 50 | \$ | \$ 350 00 | \$ | \$ None | No net loss allowable (see Instruction 10) |
| 2. Total net long-term capital gain or loss (enter as item 10 (b), page 1, amount of gain or loss shown in column 5) | \$10,048 00 | \$ | \$ | \$ | \$ | \$10,048 00 | \$ |

COMPUTATION OF ALTERNATIVE TAX

Use only (1) If you had a net long-term capital gain, and item 24, page 1, exceeds \$22,000

(2) If you had a net long-term capital loss, and such loss plus item 24, page 1, exceeds \$22,000

| | | | |
|---|--------------|--|--------------|
| 1 Net income (item 20, page 1) (See Instruction 10) | \$ 41,641 05 | 10 Normal tax (4% of line 9) | \$ 1,670 00 |
| 2 (a) Net long term capital gain (item 10 (b), page 1) | 10,048 00 | 11 Surtax on line 6. (See Instruction 29) | 4,277 92 |
| (b) Net long term capital loss (item 10 (b), page 1) | — | 12 Par. 21 tax (—1%, 1%—2%) | 5,247 92 |
| 3 Ordinary net income (line 1 minus line 2 (a) plus line 2 (b)) | \$ — | 13 () do not enter (—1%, 1%—2%) | — |
| 4 Less Personal exemption (line 13) | — | 14 30% of net long-term capital loss (30% of line 2 (b)) | — |
| 5 Credit for dependents (from Schedule E) | — | 15 Alternative tax (line 14 plus line 13) | — |
| 6 Balance due (tax minus credits) | \$ — | 16 Total tax (line 15 plus line 10) | \$ 5,917 92 |
| 7 Less interest on GI (see instructions) | — | 17 Excess of alternative tax over normal tax (line 16 minus line 10) | \$ 4,247 92 |
| 8 Excess of credit (line 5 minus line 7) | — | 18 Total tax (line 16 plus line 17) | \$ 10,165 84 |
| 9 Balance due (line 6 minus line 8) | \$ — | 19 Total tax (line 18 plus line 19) | \$ 10,165 84 |

Schedule G—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS (See Instruction 10)

| 1 Kind of property | 2 Date acquired | 3 Gross sales price (contract price) | 4 Cost or other basis | 5 Expense of sale and cost of improvements subsequent to acquisition or March 1, 1913 | 6 Depreciation allowed (or allowable) since acquisition or March 1, 1913 (Capitalize in Schedule E) | 7 Gain or loss (column 3 plus column 6 minus the sum of columns 4 and 5) |
|---|-----------------|--------------------------------------|-----------------------|---|---|--|
| Brick building | 7-1-35 | \$20,000 00 | \$35,000 00 | \$ 1,000 00 | \$ 3,750 00 | \$ 12,250 00 |
| | | | | | See statement attached. | |
| Total net gain (or loss) (enter as item 10 (c), page 1) | | | | | | Loss \$ 12,250 00 |

State the family, fiduciary, or business relationship to you, if any, of purchaser of any of the items on this page.

None

If any of such items were acquired by you other than by purchase, explain fully how acquired.

See statement attached

3 (concluded). Federal Tax Return—Long Form

Schedule H—EXPLANATION OF DEDUCTIONS CLAIMED IN ITEMS 13, 14, 15, 16, 17, AND 18

Page 4

| 1. Item No. | 2. Explanation | 3. Amount | 1. Item No. (Continued) | 2. Explanation (Continued) | 3. Amount (Continued) |
|-------------|------------------------|-----------|-------------------------|----------------------------|-----------------------|
| | | \$ | | | \$ |
| | | | | | |
| | | | | | |
| | See statement attached | | | | |

Schedule I—NONTAXABLE INCOME OTHER THAN INTEREST REPORTED IN SCHEDULE B (See Instruction G)

| 1. Source of income | 2. Nature of income | 3. Amount |
|-------------------------------------|--|--------------|
| R Life Insurance Co., New York City | Proceeds of policy received on death of P. Black | \$ 10,000.00 |

Schedule J—EXPLANATION OF CREDITS CLAIMED IN ITEMS 22 AND 23 (See Instructions 22 and 23)

| (1) Personal Exemption | | | (2) Credit for Dependents | | |
|--|---|----------------|------------------------------------|---|----------------|
| Status | Number of months during the year in each status | Credit claimed | Name of dependent and relationship | Number of months during the year Under 18 years old Over 18 years old | Credit claimed |
| Single, or married and not living with husband or wife | | | Ralph Black, son | 12 | \$ 400.00 |
| Married and living with husband or wife | 12 | 2,000.00 | Mary Black, daughter | 12 | 400.00 |
| Head of family (explain below) | | | | | |
| | | | Reason for support | Physically defective and if over 18 years old incapable of self-support | |

Schedule K—COMPUTATION OF EARNED INCOME CREDIT. (See Instruction 26)

| (1) If your net income is \$3,000 or less, use only this part of schedule | (2) If your net income is more than \$3,000, use only this part of schedule |
|---|---|
| Net income (item 20, page 1) \$ | Earned net income (not more than \$14,000) \$ 10,030.79 |
| Earned income credit (10% of net income, above) | Net income (item 20, page 1) 41,641.05 |
| | Earned income credit (10% of earned net income or 10% of net income, above, whichever amount is smaller, but do not enter less than \$300) 1,003.08 |

QUESTIONS

- State your principal occupation or profession Manufacturer.
- Check whether you are a citizen ☒ or a resident alien ☐.
- Did you file a return for any prior year? Yes. If so, what was the latest year? 1939. To which collector's office was it sent? 3rd District, New York, N. Y.
- Are items of income or deductions of both husband and wife included in this return? No.
- State (a) Name of husband or wife if separate return was made Mary Black.
- (b) Personal exemption, if any, claimed thereon None.
- (c) Collector's office to which it was sent 3rd District.
- Check whether this return was prepared on the cash ☐ or accrual ☒ basis.
- Did you at any time during your taxable year own directly or indirectly any stock of a foreign corporation or a personal holding company as defined by section 501 of the Internal Revenue Code? (Answer "yes" or "no") No. (If answer is "yes," attach statement required by Instruction J.)

AFFIDAVIT. (See Instruction E)

I/we swear (or affirm) that this return (including any accompanying schedules and statements) has been examined by me/us, and to the best of my/our knowledge and belief is a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued under authority thereof

Subscribed and sworn to by Henry Black

before me this 3rd day of January, 1941

Frank E. Brown Notary Public

(Signature and title of officer administering oath)

A return made by an agent must be accompanied by power of attorney (See Instruction E)

Henry Black (Signature) (See Instruction E)

(Signature)

(If this is a joint return (not made by agent), it must be signed by both husband and wife. It must be sworn to before a proper officer by the spouse preparing the return. If neither or both prepare the return, it must be sworn to by both spouses.)

AFFIDAVIT (See Instruction E)

(If this return was prepared for you by some other person, the following affidavit must be executed)

I/we swear (or affirm) that I/we prepared this return for the person or persons named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the tax liability of the person, or persons for whom this return has been prepared of which I/we have any knowledge

Subscribed and sworn to before me this _____ day

of _____, 1941.



(Signature of person preparing the return)

(Signature of person preparing the return)

(Name of firm or employee, if any)

(Signature and title of officer administering oath)

4. State Resident Tax Return

7 30-40—1,200 000 (3 877)

Form 201 Page 1 of Return

Resident individuals subject to tax on net income must report their taxable income on page 2 of return and compute the Normal Tax and Emergency Tax on page 1.

Resident individuals having gain (or loss) from the sale or exchange of stocks, bonds, lands, buildings or other property (except land or depreciable property used in business), must report in Schedule E, page 4, of return and compute the Net Capital Gain Tax thereon.

Individuals carrying on an unincorporated business the gross income of which is more than \$10,000 or the net income more than \$5,000 (or a greater part thereof for a period less than twelve months) must make additional report thereon on Form 202 and attach to this return.

Nonresidents must use Form 203.

NEW YORK STATE INCOME TAX

RESIDENT RETURN

For the Calendar Year 1940 or Fiscal Period

1940

DO NOT WRITE IN THESE SPACES

Serial Number

Begun 19 and Ended 19

PRINT NAME AND RESIDENCE ADDRESS PLAINLY BELOW

NAME

John H. White

(First name in full—middle initials—last name in full)

728

Fourth Ave.

(No.)

(Street or avenue or rural route)

New York

New York

New York

(City)

(County)

(State)

Paid \$

Date

1. Did you file a N Y State return for 1939? **Yes** 1939? **Yes**
2. If so, give any address other than that above used on such returns **1938-2090 E. 75th St. - joint return**
3. If no return for 1939 was filed, state reasons
4. Were you married and living with your wife (or husband) during your taxable year? **Yes**
- 4a. If so, state name of your wife (or husband) **Mary L. White**
5. Did your wife (or husband) have separate income? **Yes**
- 5a. If so, is such income included in this return? **No**
6. If separate return was filed, give address on such return **2090 E. 75th St., New York City**

7. If not married, were you during your taxable year the head of a family? **No** If so, explain
8. How many dependent persons (other than husband or wife) under eighteen years of age, or mentally or physically defective, were receiving their chief support from you during your taxable year? **One**
9. What is the relationship to you of the dependent persons for whose support you claim exemption under Questions 7 and 8? **Niece**
10. If your status with respect to Questions 4-7 8 changed during the year, state the date and nature of such change

ATTACH REMITTANCE HERE

CALCULATION OF NORMAL TAX

| | |
|---|--------------|
| 11 Net income (Item 35, page 2) | \$ 35,611.69 |
| 12 Personal exemption and credit for dependents | 2,900.00 |
| 13 Taxable balance (Item 11 minus Item 12) | \$ 32,711.69 |
| 14a. Tax at 2% (First \$1000 of Item 13) | 20.00 |
| 14b. Tax at 3% (2nd and 3rd \$1000 of Item 13) | 60.00 |
| 14c. Tax at 4% (4th and 5th \$1000 of Item 13) | 80.00 |
| 14d. Tax at 5% (6th and 7th \$1000 of Item 13) | 100.00 |
| 14e. Tax at 6% (8th and 9th \$1000 of Item 13) | 120.00 |
| 14f. Tax at 7% (All over \$9000 of Item 13) | 1,659.82 |
| 15 Normal Tax (Total of Items 14a to 14f incl) | \$ 2,039.82 |

CALCULATION OF EMERGENCY TAX

| | |
|---|-------------|
| 17 Emergency Tax—1% on Item 13 | \$ 327.12 |
| SUMMARY—TOTAL TAX TO BE PAID | |
| 18 Normal Tax (Item 15) | \$ 2,039.82 |
| 19 Emergency Tax (Item 17) | 327.12 |
| 19a. Net Capital Gain Tax (Item 39, page 4) | 14.65 |
| 19b. Unincorporated Business Tax (Item 4, Sch. O p 2 of Form 202) | 132.56 |
| 20 Total Tax Due (Total of above items) | \$ 2,514.14 |

| DATE—NUMBER | AMOUNT PAID | EMERGENCY TAX | NORMAL TAX |
|-------------|-------------|---------------|------------|
| | | | |
| | | | |
| | | | |

(These spaces for office use only)

Make checks or money orders payable to STATE TAX COMMISSION Do not mail currency
The one per cent (1%) Emergency Tax (Item 19) MAY BE PAID IN FULL at the time this return is filed or it may be paid in two installments, ONE-HALF on filing and ONE-HALF on April 15, 1941.

Dated this day of 1941

(Signature of individual or agent)

(Address of Agent)

[201]

[1940]

4 (continued). State Resident Tax Return

Form 201 Page 2 of Return

RETURN OF TAXABLE INCOME SUBJECT TO NORMAL AND EMERGENCY TAX

(Include income of wife (or husband) and earnings of dependent minor children unless reported in separate returns)

| 21 Salaries, wages, fees, commissions, bonuses, etc. (See Instruction 21) | | | | AMOUNT |
|--|--------------------------------------|---------------------|--------------------------------------|---------------------|
| (a) OCCUPATION OR TRADE | (b) NAME AND ADDRESS OF EMPLOYER | (c) AMOUNT RECEIVED | (d) EXPENSES PAID (explain in Sch 1) | |
| Director's fees | Awosting Woolen Co. Boston, Mass. | 100 00 | 50 00 | 50 00 |
| 22 Interest on bank deposits, notes, mortgages, corporation bonds, etc. | | | | 1,160 00 |
| 23 Dividends | | | | 5,080 00 |
| 24 Income from partnerships, estates and trusts (furnish name and address) Enter net income (or loss) other than capital gains or capital losses from partnerships, syndicates, pools, or joint ventures. Report distributive share of net capital gain (or loss) at Item 1, Schedule E, page 4 | | | | |
| (a) Potter, White & Co., 24 Jay St., New York City | | | | 3,960 00 |
| (b) Estate of R. White (J. Clark Trustee), Boston, Mass. | | | | 4,525 00 |
| 25 Income (or loss) from business or profession (from Schedule A) | | | | 12,857 85 |
| 26 Rents and royalties (from Schedule B) | | | | 20,075 00 |
| 27 Gain (or loss) from sale or exchange of capital assets (see definition in INSTRUCTION—SCHEDULE E) | | | | |
| 28 (report in Schedule E, page 4) Report gains arising from transactions involving non capital assets (except stock in trade) at Item 29, and losses from such transactions at Item 31d. Attach a schedule similar to Schedule E, page 4, giving full details. | | | | X X X X X X X X X X |
| 29 Other income (Describe and itemize each source completely) (a) Recovery of 1931 bad debt | | | | 500 00 |
| (b) Proceeds matured endowment over premiums paid | | | | 300 00 |
| 30 Total income from above sources (Items 21 to 29) | | | | 48,507 85 |
| DEDUCTIONS | | | | |
| 31a Interest on indebtedness (explain in Schedule 1) | | | | 300 00 |
| 31b Taxes on real property (except assessments for local benefits) (explain in Schedule 1) | | | | 4,100 00 |
| 31c Other taxes (except income taxes) (explain in Schedule 1) | | | | 101 75 |
| 31d Other deductions (explain in Schedule 1) Worthless securities may not be deducted here. (Report in Schedule E, page 4) | | | | 2,110 00 |
| 32 Total deductions—(except contributions) (Items 31a to 31d), | | | | 5,611 75 |
| 33 Balance (Item 30 minus Item 32) | | | | 41,896 10 |
| 34 Contributions—These must not exceed 15% of Item 33 (explain in Schedule 2) | | | | 6,284 41 |
| 35 Net income subject to Normal and Emergency Tax (Item 33 minus Item 34) Enter on page 1, Item 11 | | | | 35,611 69 |

SCHEDULE 1

EXPLANATION OF DEDUCTIONS CLAIMED in Item 21 (d), Schedules A and B and Items 31 (a), (b), (c) and (d)

| 1 Refer to Item No. | 2 EXPLANATION | 3 AMOUNT | 4 Refer to Item No. | 5 EXPLANATION | 6 AMOUNT |
|---------------------|---------------------------|----------|---------------------|-------------------------|----------|
| 21-d | Traveling expense | 50 00 | A-20 | Tel. & Tel. | 310 90 |
| 31-a | Mortgage interest on home | 300 00 | | Postage and stationery | 408 10 |
| 31-b | Property taxes - home | 600 00 | | Light | 110 50 |
| | " " apt. house | 3,500 00 | | Messenger charges | 135 00 |
| 31-c | " " " " | 50 00 | | Miscellaneous | 25 65 |
| | " " " " | 50 00 | | " " " " | 200 00 |
| | N. Y. City sales tax | 22 00 | | Cuts and illustrations | 110 00 |
| 31-d | Theft of jewelry | 1,200 00 | A-18 | Electric sign destroyed | 450 00 |
| | Wreck of auto | 910 00 | A-19 | See Rider "A-19" | 673 00 |
| | Investment counsel | 100 00 | | | |

SCHEDULE 2

DETAILS OF DEDUCTION FOR CONTRIBUTIONS (Item 34)

| 1 NAME AND ADDRESS OF ORGANIZATION | 2 AMOUNT | 3 NAME AND ADDRESS OF ORGANIZATION | 4 AMOUNT |
|------------------------------------|----------|------------------------------------|----------|
| Cornell University, Ithaca | 7,000 00 | Philharmonic Symphony Soc., N.Y.C. | 100 00 |
| American Red Cross, N.Y.C. | 1,600 00 | | |
| Grace Church, N.Y.C. | 300 00 | Total | 9,200 00 |
| N.Y. Foundling Asylum, N.Y.C. | 200 00 | | |

THIS INFORMATION MUST BE GIVEN

- 1 Has the Federal Internal Revenue Service notified you that additional tax was due on your Federal return for either 1938 or 1939?
(Yes or No) ()
- 2 If the answer is Yes state year, 1938, \$, 1939, \$
- 3 Attach a statement giving full details.

4 (continued). State Resident Tax Return

Form 201 Page 3 of Returns

SCHEDULE A

INCOME (OR LOSS) FROM BUSINESS OR PROFESSION (Item 25 of return). Farming may be detailed on Form 207

If your GROS exceeded \$1,000

(a) Kind of business or profession Exhibit 11117 728 4th Ave. N.Y.C.

(c) Date 10-6-93 Actual

If inventories are used state, if (a) at cost or (b) at cost or market, whichever is lower. C or M

Taxpayers may submit statements attached hereto in the form in which their books are kept giving no less details than called for herein, and enter the net income (or loss) below

| | | |
|---|---------------|---|
| 4 TOTAL SALES AND INCOME FROM BUSINESS OR PROFESSIONAL SERVICES | | 196,586 50 |
| COST OF GOODS SOLD | | |
| 5 Labor | \$ 7,146 00 | 13 Salary withdrawn by taxpayer or paid to wife or minor children (Report as income at Item 21, page 2) |
| 6 Materials and supplies | 6,098 50 | 13a Other salaries and wages not reported under "Cost of Goods Sold" |
| 7 Merchandise purchased | 154,582 00 | 14 Rent for business property |
| 8 Other costs | 1,652 00 | 15 Interest on business indebtedness to others |
| 9 Plus inventory at beginning of year | 15,290 00 | 16 Taxes on business and business property (Attach Schedule) |
| 10 TOTAL | \$ 184,768 50 | 17 Depreciation and depletion (explain in Schedule C below) |
| 11 Less inventory at end of year | 21,050 09 | 18 Losses, other than capital losses, not compensated by insurance (explain in Schedule 1, page 2) |
| 12 Cost of Goods Sold (Item 10 minus Item 11) | \$ 163,718 50 | 19 Bad debts (explain in Schedule 1, page 2) |
| 22 Cost of Goods Sold PLUS TOTAL OTHER BUSINESS DEDUCTIONS (Item 12 plus Item 21) | \$ 19,790 15 | 20 Repairs and other expenses (itemize in Schedule 1, page 2) |
| 23 NET INCOME (OR LOSS) FROM BUSINESS OR PROFESSION (Item 4 minus Item 22) Enter at Item 25, page 2 | \$ 183,508 65 | 21 TOTAL OTHER BUSINESS DEDUCTIONS |
| Note—If you paid to any resident individual personal service compensation, rent interest or other fixed or determinable income of \$1,000 or over, if single, or \$2,500 or over, if married, returns of individual on Forms 105 and 106 must be filed. | | \$ 12,857 85 |
| If you paid any nonresident individual personal service compensation earned in New York State in the foregoing amounts, withholding returns on Forms 102 and 103 must be filed. | | |

SCHEDULE B
INCOME FROM RENTS AND ROYALTIES—(See Instruction 26.)

| (a) KIND OF PROPERTY AND LOCATION <i>If the property is owned jointly or in common with others, a partnership return must be filed</i> | (b) GROSS AMOUNT OF RENTS | (c) DEPRECIATION AND DEPLETION (explain in Schedule C) | (d) REPAIRS | (e) OTHER EXPENSES (explain in Schedule 1) | (f) NET AMOUNT OF RENTS (enter at Item 26, page 2) |
|---|---------------------------|--|-------------|--|--|
| Apt. house, Yonkers, N. Y. | \$ 19,725 00 | \$ 5,100 00 | \$ --- -- | \$ 4,700 00 | \$ 9,925 00 |
| Store - floor sublet | 200 00 | | 50 00 | | 150 00 |
| Royalties - copyright | 1,110 00 | | | 110 00 | 1,000 00 |
| Royalties - patent | 10,000 00 | 1,000 00 | | | 9,000 00 |

SCHEDULE C

EXPLANATION OF DEDUCTION FOR DEPRECIATION AND DEPLETION CLAIMED IN SCHEDULES A AND B
If the property was acquired after January 1, 1919, base depreciation on the cost thereof. If acquired prior to January 1, 1919, base depreciation on the January 1, 1919 value.

| 1 Refer to Item No | 2 KIND OF PROPERTY (Principal material of which constructed) AND LOCATION | 3 DATE ACQUIRED | 4 COST | 5 VALUE ON JANUARY 1, 1919 (If acquired prior thereto) | DEPRECIATION AND DEPLETION | | |
|--------------------|---|-----------------|-------------|---|----------------------------|-------------------------|------------------------|
| | | | | | 6 RATE | 7 AMOUNT IN PRIOR YEARS | 8 AMOUNT FOR THIS YEAR |
| A-17 | Furniture & fixtures | 1-1-33 | \$ 2,000 00 | \$ --- -- | 10% | \$ 1,400 00 | \$ 200 00 |
| A-17 | Motor trucks | 1-1-37 | 1,000 00 | --- | 5% | 1,000 00 | --- |
| B-c | Fire house brick-Yallahs | 1-1-17 | 140,000 00 | 172,000 00 | 7 1/2% | 1,000 00 | 5,000 00 |
| B-c | Radio patent | 1-1-36 | 17,000 00 | --- | 1/17 | 7,000 00 | 1,000 00 |

SCHEDULE D

Enter here all income received during the taxable year not included on page 2 (See Instruction E)

| 1 DEBIT | 2 AMOUNT | 3 CREDIT | 4 AMOUNT |
|--|-------------|---------------------------------|-------------|
| N. Y. State bond interest..... | \$ 1,000 00 | U. S. Liberty Bond interest.... | \$ 7,125 00 |
| Savings & Loan Bank of N. Y. int. | 200 00 | | |

4 (concluded). State Resident Tax Return

RETURN OF NET CAPITAL GAIN SUBJECT TO NET CAPITAL GAIN TAX

SCHEDULE E—GAINS AND LOSSES FROM SALES OR EXCHANGES OF STOCKS, BONDS, LANDS, BUILDINGS, AND OTHER PROPERTY.—(See Instruction—Schedule E)

Include all property sold or exchanged, except stock in trade, or property includable in inventory or property held primarily, for sale to customers in the ordinary course of trade or business, or land or depreciable property used in business. Losses through securities claimed to be worthless are to be reported here.

Each transaction must be computed separately. As to property acquired prior to January 1, 1919, in the case of an actual gain, use cost or January 1, 1919 value, whichever is higher, in the case of an actual loss, use cost or January 1, 1919 value, whichever is lower. Where the securities sold were owned jointly or in common with others or where an interest in a group, pool, syndicate, or joint venture was held, a partnership return must be filed. The share of each such joint owner etc. must be reported in the individual return as partnership gain or loss.

[illegible]

1 If you were a member of a partnership, include here your distributive share of net capital gain (or loss) of partnership as reported at Item 4, column 6, page 1 of partnership return. **Potter, White & Co., 24 Jay St., N.Y.C.**

2. Totals

3 Net capital gain (excess of column 8 over column 9) Enter at Item 36 below

1. If stock dividends or stock rights were received or stock rights exercised during the period of ownership with respect to any of the stocks sold, state whether and on January 1, 1919 value (if acquired prior to January 1, 1919) were properly adjusted.

2. If property sold was acquired prior to January 1, 1919, state statement showing (a) original purchase price, (b) permanent improvements since January 1, 1919 (c) depreciation on purchase (d) exchange value January 1, 1919 (e) permanent improvements since January 1, 1919 (f) depreciation since January 1, 1919 (g) depreciation on purchase.

CALCULATION OF NET CAPITAL GAIN TAX

[illegible]

This space for office use only

AUDITED BY

5. State Nonresident Tax Return

| | | |
|--|---|--|
| 7-30-40—120,000 (5-575) | Form 203—Page 1 of Return | <h1 style="margin: 0;">1940</h1> <p style="font-size: small; margin: 0;">DO NOT WRITE IN THESE SPACES</p> <p style="margin: 0;">Serial Number _____</p> <p style="margin: 0;">Paid \$ _____ Date _____</p> |
| <p>To be used by individuals who are residents of New York State, deriving income from:</p> <ul style="list-style-type: none"> (a) property situated within State of New York; (b) a business, trade or profession carried on within State of New York; (c) services rendered while in State of New York. <p>Nonresident individuals subject to tax on net income must report their taxable income on page 2 of return and compute the Normal Tax and Emergency Tax on page 1.</p> <p>Nonresident individuals having gain or loss from the sale or exchange of property situated in New York State must report in Schedule F, page 4 of return and compute the Net Capital Gain Tax thereon.</p> <p>If income was received from business carried on in New York State use in addition to this form, Form 202 for computing the Unincorporated Business Tax and attach to this return.</p> | | |
| <h2 style="margin: 0;">NEW YORK STATE INCOME TAX NON-RESIDENT RETURN</h2> <p style="margin: 0;">FOR THE CALENDAR YEAR 1940 OR FISCAL PERIOD</p> <p style="margin: 0;">Begun - - - 19 and Ended - - - 19</p> <hr/> <p style="text-align: center; font-weight: bold;">PRINT NAME AND RESIDENCE ADDRESS PLAINLY BELOW</p> | | |
| <p>NAME _____ <i>(First name in full—middle initials—last name in full)</i></p> <p>RESIDENCE ADDRESS _____ <i>(No.) (Street or avenue or rural route)</i></p> <p>_____ <i>(City) (County) (State)</i></p> | | |
| <p>1 Did you file a N Y State return for 1938? _____ 1939? _____</p> <p>1a If so give any address other than that above used on such returns _____</p> <p>1b If no return for 1939 was filed, state reasons _____</p> <p>2 Were you married and living with your wife (or husband) during your taxable year?</p> <p>2a If so, state name of your wife (or husband) _____</p> <p>3 Did your wife (or husband) have separate income?</p> <p>4 If so, is such income included in this return?</p> <p>5 If separate return was filed, give address on such return _____</p> <p>6 If not married, were you during your taxable year the "head of a family"? If so, explain _____</p> <p>7 How many dependent persons (other than husband or wife) under eighteen years of age, or mentally or physically defective, were receiving their chief support from you during your taxable year?</p> <p>7a What is the relationship to you of the dependent persons for whose support you claim exemption under Questions 6 and 7?</p> <p>8 If your status with respect to Questions 2, 6 and 7 changed during the year, state the date and nature of such change _____</p> | | |
| CALCULATION OF NORMAL TAX | | |
| <p>9 Net income (Item 30, page 2) \$ _____</p> <p>10 Personal exemption and credit for dependents \$ _____</p> <p>11 Taxable balance (Item 9 minus Item 10) \$ _____</p> <p>12a Tax at 2% (First \$1000 of Item 11) \$ _____</p> <p>12b Tax at 3% (2nd and 3rd \$1000 of Item 11) \$ _____</p> <p>12c Tax at 4% (4th and 5th \$1000 of Item 11) \$ _____</p> <p>12d Tax at 5% (6th and 7th \$1000 of Item 11) \$ _____</p> <p>12e Tax at 6% (8th and 9th \$1000 of Item 11) \$ _____</p> <p>12f Tax at 7% (All over \$9000 of Item 11) \$ _____</p> <p>12g Normal Tax (Total of Items 12a to 12f incl) \$ _____</p> | <p>13 Emergency Tax—1% on Item 11 \$ _____</p> <p style="text-align: center; font-weight: bold;">SUMMARY—TOTAL TAX TO BE PAID</p> <p>14 Normal Tax (Item 12g) \$ _____</p> <p>15 Emergency Tax (Item 13) \$ _____</p> <p>16 Net Capital Gain Tax (Item 34, page 4) \$ _____</p> <p>17 Unincorporated Business Tax (Item 4 Sch O) [p 2 of Form 202] \$ _____</p> <p>18a Total Tax Due (Total of Items 14 15 16 and 17) \$ _____</p> <p>18b Less Tax Withheld at Source* \$ _____</p> <p>18c Balance Due (Item 18a minus Item 18b) \$ _____</p> <p>* If item 18b exceeds item 18a this return will be considered as a claim for refund.</p> | |
| DATE—NUMBER | AMOUNT PAID | EMERGENCY TAX |
| | | |
| (These spaces for office use only) | | |
| <p>The one per cent (1%) Emergency Tax if it is not paid by the time this return is filed, or it may be paid in two installments, ONE-half by the time this return is filed or MAY BE PAID in full, and ONE QUARTER within six months from the date this return is filed.</p> | | |
| <p>I hereby certify that this return, including the accompanying schedules and statements, has been examined by me, and to the best of my knowledge and belief, is a true and complete return made in good faith for the taxable year stated, pursuant to the New York State Tax Law and the Regulations.</p> <p>Date this _____ day of _____, 1941</p> <p style="text-align: right;">_____ (Signature of individual or agent)</p> <p style="text-align: right;">_____ (Address of Agent)</p> | | |

5 (continued). State Nonresident Tax Return

Form 203—Page 2 of Return
RETURN OF TAXABLE INCOME SUBJECT TO NORMAL AND EMERGENCY TAX

| 19 Salaries wages fees commissions, bonuses etc (See Instruction 19) | | | | AMOUNT |
|--|----------------------------------|---------------------|--------------------------------------|-----------|
| (a) OCCUPATION OR TRADE | (b) NAME AND ADDRESS OF EMPLOYER | (c) AMOUNT RECEIVED | (d) EXPENSES PAID (explain on Sch 2) | |
| | | \$ | \$ | \$ |
| 20 Income from partnerships estates and trusts (furnish name and address) Enter net income (or loss) other than capital gains or capital losses from partnerships, syndicates, pools, or joint ventures. Report distributive share of net capital gain (or loss) at Item 1 Schedule F, page 4 | | | | |
| (a) | | | | \$ |
| (b) | | | | \$ |
| 21 Income (or loss) from business or profession (from Schedule A) | | | | \$ |
| 22 Income from rents from property situated within the State of New York (from Schedule B) | | | | \$ |
| 23 Gain (or loss) from sale or exchange of capital assets (See definition in INSTRUCTION—SCHEDULE F) (Report on Schedule F, page 4) Report gains arising from transactions involving non-capital assets (except stock in trade) at Item 24 and losses from such transactions at Item 26. Attach a schedule similar to Schedule F page 4, giving full details | | | | XXXXXX XX |
| 24 Other income from sources within the State of New York (Describe each source) | | | | \$ |
| 25 Total income from above sources (Items 19 to 24) | | | | \$ |
| 26 DEDUCTIONS not claimed above (explain in Schedule 2) Deductions allowable to a nonresident are limited to expenses incurred in connection with the production of taxable income from sources within the State or losses from business carried on or property owned within the State. (See Instruction 26) | | | | |
| (a) | | \$ | | \$ |
| (b) | | | | \$ |
| 27 Total deductions (except contributions) | | | | \$ |
| 28 Balance (Item 25 minus Item 27) | | | | \$ |
| 29 Contributions (See Instruction 29) These must not exceed 15% of Item 28 (explain in Schedule 3) | | | | \$ |
| 30 Net income subject to Normal and Emergency Tax (Item 28 minus Item 29) Enter on page 1 Item 9 | | | | \$ |

SCHEDULE 1

Details of basis used in apportioning income, if any, earned partly within and partly without the State of New York.

| 1 Refer to Item No | 2 Explanation |
|--------------------------|------------------|
| | |
| | |
| | |
| | |
| | |

SCHEDULE 2

Explanation of deductions claimed in Item 19 (d), Schedules A and B and Items 26 (a) and (b)

| 1 REFER TO ITEM NO. | 2 EXPLANATION | 3. AMOUNT | 4 REFER TO ITEM NO. | 5 EXPLANATION | 6. AMOUNT |
|------------------------------|------------------|--------------|------------------------------|------------------|--------------|
| | | \$ | | | \$ |
| | | | | | |
| | | | | | |

SCHEDULE 3

Details of contributions to the State of New York, or any political subdivision thereof, for exclusively public purposes, or to charitable, religious, scientific and educational corporations, incorporated by, or associations organized under, the LAWS OF THE STATE OF NEW YORK claimed as deduction at Item 29 above.

| 1 NAME AND ADDRESS OF ORGANIZATION | 2. AMOUNT | 3. NAME AND ADDRESS OF ORGANIZATION | 4. AMOUNT |
|---------------------------------------|--------------|--|--------------|
| | \$ | | \$ |
| | | | |

THIS INFORMATION MUST BE GIVEN

- 1 Has the Federal Internal Revenue Bureau notified you that additional tax was due on your Federal return for either 1938 or 1939?
(Answer Yes or No)
2. If the answer is Yes, state amount. 1938, \$; 1939, \$
3. Attach a statement giving full details.

5 (continued). State Nonresident Tax Return

Form 203—Page 3 of Return

SCHEDULE A

Income (or loss) from business or profession carried on wholly or partly within the State of New York
(Item 21 of return) Farming may be detailed on Form 207

If the business is carried on both within and without the State (as defined in the regulations) report the total income from the business, and exhibit apportionment in Schedule E.

1 (a) Kind of business (b) Business address

2 State if a cash or accrual basis is used

3 If inventories are used state if (a) at cost or (b) at cost or market, whichever is lower

Taxpayer may submit statements attached hereto in the form in which the books are kept, giving no less details than called for herein and enter the net income

(or less) below

TRADING OR OPERATING INCOME (OR LOSS)

4 TOTAL SALES AND INCOME FROM BUSINESS OR PROFESSIONAL SERVICES

COST OF GOODS SOLD

5 Labor

6 Materials and supplies

7 Merchandise purchased

8 Other costs

9 Plus inventory at beginning of year

10 TOTAL

11 Less inventory at end of year

12 COST OF GOODS SOLD (Item 10 minus Item 11)

13 Amount withdrawn by taxpayer or paid to wife or minor children (report at Item 19 p. 2)

13a. Salaries and wages not reported under "Cost of Goods Sold"

14 Rent for business property

15 Interest on business indebtedness to others

16 Taxes on business and business property (Attach Schedule)

17 Depreciation and depletion (explain in Sch. C below)

18 Losses, other than capital losses not compensated by insurance (explain in Sch. 2, page 2)

19 Bad debts (explain in Sch. 2, page 2)

20 Repairs and other expenses (itemize in Sch. 2, page 2)

21 TOTAL OTHER BUSINESS DEDUCTIONS

22 COST OF GOODS SOLD PLUS TOTAL OTHER BUSINESS DEDUCTIONS (Item 12 plus Item 21)

23 NET TRADING OR OPERATING INCOME (OR LOSS) FROM BUSINESS OR PROFESSION (Item 4 minus Item 22)

NON OPERATING INCOME (OR LOSS) OF THE BUSINESS OR PROFESSION

Do not include income from rents which must be reported in Schedule B below

24 Interest

25 Dividends from stocks carried as business assets

26 Gain (or loss) from sale or exchange of stocks, bonds or other intangible property, not dealt in as a business, but carried as business assets Report in Schedule F, page 4 See Item 23 page 2, for reporting sale or exchange of non capital assets

27

28

29

30 TOTAL NET INCOME (OR LOSS) FROM BUSINESS OR PROFESSION

If business is carried on (as defined in the regulations) only within the State of New York

on page 2 of return or both within and without the State of New York

IF GROSS INCOME FROM BUSINESS CARRIED ON IN NEW YORK STATE EXCEEDED \$10,000 OR IF NET INCOME EXCEEDED \$3,000 (OR A PRORATA PART THEREOF FOR A PERIOD LESS THAN TWELVE MONTHS) MAKE ADDITIONAL REPORT ON FORM 202 AND ATTACH TO THIS RETURN.

SCHEDULE B

Income from rents from property situated within the State of New York—(See Instruction 22)

| (a) | (b) | (c) | (d) | (e) | (f) | (g) |
|-------------------------------|-----------------------|--|---------|--------------------|--|--|
| KIND OF PROPERTY AND LOCATION | GROSS AMOUNT OF RENTS | DEPRECIATION AND DEPLETION (explain in Schedule C) | REPAIRS | INTEREST AND TAXES | OTHER EXPENSES (explain in Schedule 2) | NET AMOUNT OF RENTS (enter at Item 22, page 2) |
| | \$ | \$ | \$ | \$ | \$ | \$ |
| | | | | | | |
| | | | | | | |

SCHEDULE C

Explanation of deduction for depreciation and depletion claimed in Schedules A and B

If property was acquired after January 1, 1919, base depreciation on cost thereof If acquired prior to January 1, 1919, base depreciation on the January 1, 1919 value

| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|------------------|---|---------------|------------------------------|--|---------------------------------|-----------------------|----------------------|
| REFER TO ITEM NO | KIND OF PROPERTY (Principal material of which constructed) AND LOCATION | DATE ACQUIRED | COST (exclude value of land) | VALUE DN JAN 1, 1919 (if acquired prior thereto) | DEPRECIATION AND DEPLETION RATE | AMOUNT IN PRIOR YEARS | AMOUNT FOR THIS YEAR |
| | | | \$ | \$ | | \$ | \$ |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |

5 (concluded). State Nonresident Tax Return

Form 203—Page 4 of Return.

SCHEDULE D

If you carry on business (as defined in the regulations) both within and without the State of New York, give list of all places, BOTH WITHIN AND WITHOUT the State, where you carry on business

| Line No | 1 STREET ADDRESS | 2. CITY AND STATE | 3 DESCRIPTION (Branch/office agency, factory etc.) |
|---------|------------------|-------------------|---|
| 1 | | | |
| 2 | | | |
| 3 | | | |

SCHEDULE E

Allocation of factors used in apportionment of income, in accordance with method prescribed in Article 457 of the New York State Income Tax Regulations

To be submitted only by nonresidents carrying on business (as defined in the regulations) both within and without the State of New York

| Line No | 1 DESCRIPTION OF ITEMS USED AS FACTORS | 2 TOTALS (Within and without the State) | 3 NEW YORK STATE AMOUNTS | 4 PER CENT COLUMN 3 IS OF COLUMN 2 |
|---------|--|--|-----------------------------|--|
| 1 | (1) VALUE OF THE REAL AND TANGIBLE PERSONAL PROPERTY OF THE BUSINESS | xxx xxx xxx xx | xxx xxx xxx xx | |
| 2 | (a) At the beginning of the period covered by the return | \$ | \$ | |
| 3 | (b) At the end of the period covered by the return | \$ | \$ | |
| 4 | TOTAL OF LINES 2 AND 3 | \$ | \$ | |
| 5 | AVERAGE—[half of amounts on line 4] | \$ | \$ | % |
| 6 | (2) WAGES, SALARIES AND OTHER PERSONAL SERVICE COMPENSATION PAID DURING THE YEAR | | | % |
| 7 | (3) GROSS SALES OF MERCHANDISE, OR CHARGES FOR SERVICES, DURING THE YEAR | | | % |
| 8 | (4) Total of percentages in column 4 | | | |
| 9 | (5) Average of percentages (Divide total percentages (Item 4) by 3) Apply Average percentage (Item 5) to Item 10 Schedule A and enter at Item 21 page 2 of return | | | % |

RETURN OF NET CAPITAL GAIN SUBJECT TO NET CAPITAL GAIN TAX

SCHEDULE F
GAINS AND LOSSES FROM SALES OR EXCHANGES OF LANDS, BUILDINGS AND TANGIBLE PERSONAL PROPERTY
SITUATED WITHIN NEW YORK STATE.

(See Instruction—Schedule F)
Include all property having a situs within the state sold or exchanged, except stock in trade, or property includable in inventory or property held primarily for sale to customers in the ordinary course of trade or business or land or depreciable property used in business

| 1 | 2 | 3 | 4 | 5 | 6 | 7 | 8 |
|-------------|--|-------------|------------------------|--|---|------|----------|
| DESCRIPTION | DATE ACQUIRED | SALES PRICE | COST OR OTHER BASIS | VALUE ON JANUARY 1 1919 (if acquired prior thereto) | DEPRECIATION Allowed or allowable | GAIN | LOSS |
| | | \$ | \$ | \$ | \$ | \$ | \$ |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| | | | | | | | |
| 1 | If you were a member of a partnership, include here your distributive share of net capital gain (or loss) of partnership as reported in partnership return | | | | | | |
| 2 | Totals | | | | | | |
| 3 | Net capital gain (excess of column 7 over column 8) Enter at Item 31 below | | | | | | XXXXX XX |

CALCULATION OF NET CAPITAL GAIN TAX

| | | | | | |
|-----|---|----|-----|--|----|
| 31 | Net capital gain (Item 3—Schedule F) above | \$ | 33a | Tax at 1% (First \$1,000 of Item 33) | \$ |
| 31a | Less capital deductions (submit details) | \$ | 33b | Tax at 1½% (2nd and 3rd \$1,000 of Item 33) | |
| 31b | Balance | \$ | 33c | Tax at 2% (4th and 5th \$1,000 of Item 33) | |
| 32 | Balance of personal ex-emption not deducted in 1919 | \$ | 33d | Tax at 2½% (6th and 7th \$1,000 of Item 33) | |
| 33 | Amount subject to Net Capital Gain Tax | \$ | 33e | Tax at 3% (8th and 9th \$1,000 of Item 33) | |
| | | | 33f | Tax at 3½% (All over \$9,000 of Item 33) | |
| | | | 34 | Net Capital Gain Tax (Total of Items 33a to 33f and) Enter item 34 on page 1, Item 16 | \$ |

* IMPORTANT—In computing the tax on net capital gain no exemption is allowed for the personal exemption which case the amount of exemption, unless the computation of the Normal Tax may be offset against net capital gain

This Space for Office Use Only

AUDITED BY

State of Connecticut

SUCCESSION TAX RETURN

of estate of _____ who died.

a resident of _____

~~Use~~ space should be left blank but where necessary "none" or "none claimed" should be inserted. If any schedule is insufficiently large, insert extra sheet. Mail one copy direct to the Tax Commissioner and file the other with the Court of Probate within twelve months after decedent's death.

ITEMS COMPRISING GROSS TAXABLE ESTATE

Schedule A

Final appraised value of the inventory filed in the Connecticut Probate Court. \$.....

Schedule B

List here

- 1 After discovered property not included on inventory.
- 2 Property owned by decedent jointly with another or others and not included on inventory.
- 3 Property transferred by gift in contemplation of death.
- 4 Property transferred by gift intended to take effect in possession or enjoyment at or after death.
- 5 Please answer the two following questions Yes or No

(A) Did decedent within one year prior to death give property to any person related by blood or marriage?

(B) Did decedent at any time prior to death create any trusts, other than insurance trusts?

| DESCRIPTION OF PROPERTY | VALUE |
|-------------------------|-------|
| | |

Schedule C

The following notes, credits and other choses in action (not including stocks or bonds) were sold or otherwise reduced to possession at a gain over inventory value, as follows (Do not include income accruing after death.)

| DESCRIPTION OF PROPERTY | INVENTORY VALUE | AMOUNT REALIZED | GAIN |
|-------------------------|-----------------|-----------------|------|
| | | | |

Gross Taxable Estate.....

APPENDIX D—STATE DEATH TAX RETURN (CONTINUED) 823

DEDUCTIONS

No deduction will be allowed in the ascertainment of the net taxable estate for any schedule left unexecuted. For non-resident states see statute.

Schedule D Claims allowed are as follows

(Where taxes are listed please state as of which assessment date.)

If debts of decedent were secured by collateral, please list such collateral.

| CLAIMANT | SUBJECT OF CLAIM | AMOUNT |
|----------|------------------|--------|
| | | |
| | | Total, |

Schedule E

Funeral expenses are as follows

| TO WHOM PAID | IN CONSIDERATION OF | AMOUNT |
|--------------|---------------------|--------|
| | | |
| | | Total, |

Schedule F

Execut Administrat fee, .. \$..

Schedule G

The allowance decreed by court of probate for the support of

per month for months, .. \$..

Schedule H

Unpaid mortgages on property owned by decedent at death, not deducted in inventory, are as follows

| MORTGAGE | PROPERTY OF DECEDENT INCUMBERED | AMOUNT |
|----------|---------------------------------|--------|
| | | Total, |

Schedule I

The following notes credits and other choices in action (*not including stocks or bonds*) were sold at a loss from inventory value as follows:

| DESCRIPTION OF PROPERTY | INVENTORY VALUE | AMOUNT REALIZED | LOSS |
|----------------------------|--------------------|--------------------|------|
| | | | |

Schedule J Deductible Administration Expenses Please consult statute as to deductibility
Incidental expenses totalling \$100 or less may be summarized in one item

| TO WHOM PAID | IN CONSIDERATION OF | AMOUNT |
|--------------|---------------------|---|
| | | <div data-bbox="869 1503 916 1521">Total,</div> |

Total Deductions claimed. \$

APPENDIX D—STATE DEATH TAX RETURN (CONCLUDED) 827

| | | |
|--|--|-------------|
| K-2 Charitable, public, and similar gifts and bequests | | |
| Specific exemption 1926 Federal Estate Tax | | 100,000--00 |
| Total Deductions | | |
| Total Gross Estate | | |
| Total Deductions | | |
| Net Estate For Tax 1926 Federal Estate Tax | | |
| 4. Total Amount Federal Estate Tax 1926 Act | | |
| 5. 80% of which is | | |
| 6. Total Amount of death taxes paid or payable to this or any other state | | |
| 7. Connecticut Estate Tax Due (Item 5 less Item 6) | | |

JURAT

We (I) Administrator—Executor—Custodian—Transferee—Trustee—do hereby solemnly swear (affirm) that hereon is listed all of the property, tangible or intangible forming the Gross Estate of the decedent so far as it has come into knowledge and information that to the best of knowledge, information and belief, the value shown for the property listed hereon is the same as listed and shown in the Federal Estate Tax Return, as are also the debts, expenses and other deductions from the Gross Estate.

Name Address
Name Address
Name Address

Subscribed and Sworn to before me at, 193 this
day of

Notary-Public.

Name and Address of Attorney

Note Most states and the federal government do not use special forms for the reporting of estate or inheritance tax payments, but accept the statement of the estate prepared by the executor or administrator for the probate court

Appendix E—Business Tax Forms

1. Federal Corporation Income and Declared Value Excess-Profits Tax Return

| Form 1120 Treasury Department Internal Revenue Service | | UNITED STATES CORPORATION INCOME, DECLARED VALUE EXCESS-PROFITS, AND DEFENSE TAX RETURN | | Page 1 1940 | | | | | | | | |
|---|---|--|------|-----------------------|-----------|------------|----------|------|--|--|--|--|
| (Indicate if change) For Calendar Year 1940 or fiscal year beginning <u>1940</u> , and ended <u>1941</u> <small>PRINT FULLY CORPORATION'S NAME AND ADDRESS</small> X. Y. Z. Corporation <small>(Name)</small> 8173 N. State Street <small>(Street and number)</small> Chicago Cook Illinois <small>(City (or place) (County) (State))</small> Kind of business: Manufacturer of household goods Business group serial number (from Instruction 15): 47 | | <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <td style="width: 20%;">File Code</td> <td style="width: 20%;">Serial No.</td> <td style="width: 20%;">District</td> <td style="width: 40%;">Cash</td> </tr> <tr> <td> </td> <td> </td> <td> </td> <td> </td> </tr> </table> | | | File Code | Serial No. | District | Cash | | | | |
| File Code | Serial No. | District | Cash | | | | | | | | | |
| | | | | | | | | | | | | |
| NORMAL-TAX NET INCOME COMPUTATION | | | | | | | | | | | | |
| Item No. | GROSS INCOME | | | | | | | | | | | |
| 1 | Gross sales (where inventories are an income-determining factor) <u>\$1,457,017.39</u> Less Returns and allowances <u>\$1,968.20</u> | \$1,455,049.19 | .05 | | | | | | | | | |
| 2 | Less Cost of goods sold (From Schedule A) <u>671,909.78</u> | 783,139.41 | 50 | | | | | | | | | |
| 3 | Gross profit from sales <u>783,139.41</u> | 783,139.41 | 78 | | | | | | | | | |
| 4 | Gross receipts (where inventories are not an income-determining factor) <u>3,446.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 5 | Less Cost of operations (From Schedule B) <u>3,446.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 6 | Gross profit where inventories are not an income-determining factor <u>3,446.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 7 | Interest on loans, notes, mortgages, bonds, bank deposits, etc. (See Instruction 17-(1)) <u>1,681.20</u> | 1,681.20 | 20 | | | | | | | | | |
| 8 | Interest on obligations of the United States (From Schedule M line 15 (a) (4)) (See Instruction 17-(2)) <u>3,900.00</u> | 3,900.00 | 00 | | | | | | | | | |
| 9 | Rents (See Instruction 18) <u>3,446.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 10 | Royalties (See Instruction 19) <u>3,446.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 11 | (a) <u>3,446.00</u> (b) <u>0.00</u> | 3,446.00 | 00 | | | | | | | | | |
| 12 | Dividends (From Schedule E) <u>3,100.00</u> | 3,100.00 | 00 | | | | | | | | | |
| 13 | Other income (State nature) <u>17,825.00</u> | 17,825.00 | 00 | | | | | | | | | |
| 14 | Total income in items 3, and 6 to 13, inclusive <u>\$ 682,261.00</u> | \$ 682,261.00 | 00 | | | | | | | | | |
| DEDUCTIONS | | | | | | | | | | | | |
| 15 | Compensation of officers (From Schedule F) <u>80,000.00</u> | 80,000.00 | 00 | | | | | | | | | |
| 16 | Salaries and wages (not deducted elsewhere) <u>185,272.00</u> | 185,272.00 | 00 | | | | | | | | | |
| 17 | Rent (See Instruction 21) <u>3,588.00</u> | 3,588.00 | 00 | | | | | | | | | |
| 18 | Repairs (See Instruction 22) <u>12,014.95</u> | 12,014.95 | 95 | | | | | | | | | |
| 19 | Bad debts (From Schedule C) <u>10,689.00</u> | 10,689.00 | 00 | | | | | | | | | |
| 20 | Interest (See Instruction 24) <u>35,394.20</u> | 35,394.20 | 20 | | | | | | | | | |
| 21 | Taxes (From Schedule D) (Report declared value excess-profit tax as item 31) <u>600.00</u> | 600.00 | 00 | | | | | | | | | |
| 22 | Contributions or gifts paid (From Schedule I) <u>25,006.00</u> | 25,006.00 | 00 | | | | | | | | | |
| 23 | Losses by fire, storm, shipwreck, or other casualty, or theft. (Submit schedule, see Instruction 27) <u>65,048.00</u> | 65,048.00 | 00 | | | | | | | | | |
| 24 | Depreciation (From Schedule J) <u>10,884.45</u> | 10,884.45 | 45 | | | | | | | | | |
| 25 | Depletion of mines, oil and gas wells, timber, etc. (Submit schedule, see Instruction 28) <u>6,000.00</u> | 6,000.00 | 00 | | | | | | | | | |
| 26 | Net operating loss deduction (Submit statement, see Instruction 30) <u>126,016.59</u> | 126,016.59 | 59 | | | | | | | | | |
| 27 | Amortization (Submit schedule, see Instruction 31) <u>0.00</u> | 0.00 | 00 | | | | | | | | | |
| 28 | Other deductions authorized by law (From Schedule K) <u>0.00</u> | 0.00 | 00 | | | | | | | | | |
| 29 | Total deductions in items 15 to 28, inclusive <u>\$ 515,599.00</u> | \$ 515,599.00 | 00 | | | | | | | | | |
| 30 | Net income for declared value excess-profit tax computation (item 14 minus item 29) <u>\$ 166,662.00</u> | \$ 166,662.00 | 00 | | | | | | | | | |
| 31 | Less Declared value excess-profit tax. (See Instruction 33) <u>1,665.00</u> | 1,665.00 | 00 | | | | | | | | | |
| 32 | Net income <u>\$ 165,000.00</u> | \$ 165,000.00 | 00 | | | | | | | | | |
| 33 | Less Interest on obligations of U.S. (See Instruction 34) <u>3,900.00</u> | 3,900.00 | 00 | | | | | | | | | |
| 34 | Adjusted net income <u>\$ 161,100.00</u> | \$ 161,100.00 | 00 | | | | | | | | | |
| TOTAL INCOME, DECLARED VALUE EXCESS-PROFITS, AND DEFENSE TAXES | | | | | | | | | | | | |
| 35 | Total income and income defense taxes (line 35 plus 2) <u>\$ 33,383.35</u> | \$ 33,383.35 | 35 | | | | | | | | | |
| 36 | Less Credit for income taxes paid to a foreign country or United States possession allowed a domestic corporation (See Instruction 37) <u>33,383.35</u> | 33,383.35 | 35 | | | | | | | | | |
| 37 | Balance of income and income defense taxes <u>\$ 0.00</u> | \$ 0.00 | 00 | | | | | | | | | |
| 38 | Total declared value excess-profit and declared value excess-profit defense taxes (line 10, plus 2) <u>\$ 1,665.00</u> | \$ 1,665.00 | 00 | | | | | | | | | |
| 39 | Total income, declared value excess-profit, and defense taxes due <u>\$ 35,008.35</u> | \$ 35,008.35 | 35 | | | | | | | | | |
| AFFIDAVIT (See Instruction 5) | | | | | | | | | | | | |
| Subscribed and sworn to before me this <u>3rd</u> day of <u>January</u> , 1941. | | | | | | | | | | | | |
| Notary Public <small>(Signature of Notary Public)</small> | Notary Public <small>(Signature of Notary Public)</small> | <u>Walter Chase</u> <small>(President or other principal officer) (State title)</small> | | | | | | | | | | |
| AFFIDAVIT (See Instruction 6) | | | | | | | | | | | | |
| I/we swear (or affirm) that I/we prepared this return for the person named herein and that the return (including any accompanying schedules and statements) is a true, correct, and complete statement of all the information respecting the tax liability of the person for whom this return has been prepared of which I/we have any knowledge. | | | | | | | | | | | | |
| Subscribed and sworn to before me this <u>3rd</u> day of <u>January</u> , 1941. | | | | | | | | | | | | |
| Notary Public <small>(Signature of Notary Public)</small> | <u>William Schwartz</u> <small>(Signature of person preparing the return)</small> | | | | | | | | | | | |
| NOTE — In order that this return may be accepted as meeting the requirements of the Internal Revenue Code, the data called for herein must be set forth FULLY and CLEARLY. | | | | | | | | | | | | |

1 (continued). Federal Corporation Income and Declared Value Excess-Profits Tax Return

| DECLARED VALUE EXCESS-PROFITS AND DECLARED VALUE EXCESS-PROFITS DEFENSE TAX COMPUTATION (See Instruction 34) | | | | Page 2 |
|--|-----------------|-------------|------------------------|--------|
| | Column 1 | Col. 2 Rate | Column 3 Amount of Tax | |
| 1 Net income for declared value excess profits tax computation (Item 30, page 1) | \$ 145,882.56 | | | |
| 2 Value of capital stock as declared in your capital stock return for the year ended June 30, 1940 (or for year ended June 30, 1941, if your income tax fiscal year began in 1940 and ended on or after July 31, 1941) | \$ 1,200,000.00 | | | |
| 3 Excess of line 1 over line 2 | \$ 120,000.00 | | | |
| 4 Amount taxable at 6 percent (5 percent of line 2 but not more than line 3) and tax | \$ 24,828.36 | 6% | \$ 1,477.34 | |
| 5 Balance taxable at 12 percent (line 3 minus line 4 column 1), and tax | | 12% | \$ 1,477.34 | |
| 6 Total declared value excess profits tax (total of line 4, column 3, and line 5, column 3) | | | \$ 2,954.68 | |
| 7 Declared value excess-profits defense tax (10 percent of line 3) | | | \$ 12,000.00 | |
| 8 Total income tax (total of line 6, column 3, and line 7, column 3) | | | \$ 14,954.68 | |
| 9 Normal tax net income (Item 30, page 1) | \$ | | | |
| 10 Portion of line 9 (not in excess of \$5,000) and tax at 13.5 percent | | 13.5% | | |
| 11 Portion of line 10 (in excess of \$5,000 and not in excess of \$20,000), and tax at 15 percent | | 15% | | |
| 12 Portion of line 10 (in excess of \$20,000), and tax at 17 percent | | 17% | | |
| 13 Total income tax (total tax in column 3 of lines 10, 11, and 12) | | | | |
| 14 Income defense tax (10 percent of line 13) | | | | |
| 15 CORPORATIONS WITH NORMAL-TAX NET INCOMES OF MORE THAN \$25,000 AND LESS THAN \$50,000 (See Instruction 35-1) | | | | |
| 16 Normal tax net income (Item 30, page 1) | \$ 25,000.00 | | | |
| 17 Portion of line 16 in the amount of \$25,000, and tax | | | \$ 3,750.00 | |
| 18 Portion of line 16 (in excess of \$25,000), and tax at 35 percent | | 35% | | |
| 19 Total income tax (total tax in column 3 of lines 17 and 18) | | | | |
| 20 Income defense tax | | | | |
| (a) If line 17 is less than \$31,954.30 (\$377.50 plus 8.3 percent of line 19, column 1) | | | | |
| (b) If line 17 is \$31,954.30 or more (1.9 percent of line 19) | | | | |
| 21 CORPORATIONS WITH NORMAL-TAX NET INCOMES OF \$50,000 OR MORE (See Instruction 35-2) | | | | |
| 22 Normal tax net income (Item 30, page 1) | \$ 132,097.29 | | | |
| 23 Income tax (22.1 percent of line 22) | | 22.1% | \$ 29,374.50 | |
| 24 Income defense tax (1.9 percent of line 22) | | | \$ 2,509.85 | |
| 25 SPECIAL CLASSES OF CORPORATIONS NOT SUBJECT TO GRADUATED INCOME TAX RATES (See Instruction 34) | | | | |
| (I) FOREIGN CORPORATIONS ENGAGED IN BUSINESS WITHIN UNITED STATES (See Instruction 35-3) | | | | |
| 26 Normal tax net income (Item 30, page 1) | \$ | | | |
| 27 Income tax (22.1 percent of line 26) | | 22.1% | | |
| 28 Income defense tax (1.9 percent of line 26) | | | | |
| (II) MUTUAL INVESTMENT COMPANIES (See Instruction 35-4) | | | | |
| 29 Adjusted net income (not including net operating loss deduction) (Item 24, page 2, plus item 26, page 1) | \$ | | | |
| 30 Less Basic surtax credit (Submit schedule) | | | | |
| 31 Balance subject to income tax | | | | |
| 32 Income tax (22.1 percent of line 30) | | 22.1% | | |
| 33 Income defense tax (1.9 percent of line 30) | | | | |
| 34 Total income tax (line 15, 20, 23, 33, or 31, above, whichever is applicable) | | | \$ 30,740.80 | |
| 35 Total income defense tax (line 16, 21(a), 21(b), 24, 27, or 32, above, whichever is applicable) | | | \$ 2,509.85 | |
| 36 Total income and income defense taxes | | | \$ 33,250.65 | |

| Schedule A—COST OF GOODS SOLD (See Instruction 19) | | Schedule B—COST OF OPERATIONS (When reported on tax and 1, income-defining order) | |
|---|---------------|---|----|
| Inventory at beginning of year—C or M | \$ 182,384.90 | Salaries and wages— | \$ |
| Material or merchandise bought for manufacture or sale— | 497,748.37 | Other costs (to be detailed)— | |
| Salaries and wages— | 282,181.40 | (a) | |
| Other costs per books (Attach itemized schedule)— | 47,160.01 | (b) | |
| Total— | \$ 862,374.68 | (c) | |
| Less Inventory at end of year—C or M | 179,227.58 | (d) | |
| Cost of goods sold (enter as item 5, page 1) | \$ 683,147.10 | (e) | |
| Total (enter as item 5, page 1) | \$ 683,147.10 | Total (enter as item 5, page 1) | \$ |

| Schedule C—CAPITAL GAINS AND LOSSES (See Instruction 20) | | | | | | |
|---|------------------|--|------------------------|--|---|---|
| 1. Description of Property | 2. Date Acquired | 3. Date Sold or Disposed of (Contract price) | 4. Cost or Other Basis | 5. Depreciation Allowed (See Instructions 20 and 21) | 6. Gain or Loss (Enter as item 5, page 1) | 7. Gain or Loss (Enter as item 5, page 1) |
| SHORT-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR NOT MORE THAN 12 MONTHS | | | | | | |
| (a) W. Corp. stock | 1-15-38 | 1-15-40 | \$ 80,000.00 | | \$ 10,000.00 | \$ 10,000.00 |
| (b) M. Corp. stock | 1-15-40 | 1-15-40 | \$ 81,000.00 | | \$ 75,000.00 | \$ 6,000.00 |
| Total net short-term capital gain (or loss) (Enter as item 11 (c) page 1) | | | | | \$ 16,000.00 | \$ 16,000.00 |
| LONG-TERM CAPITAL GAINS AND LOSSES—ASSETS HELD FOR MORE THAN 12 MONTHS | | | | | | |
| (a) Brown Co. | 9-20-34 | 9-20-34 | \$ 20,000.00 | | \$ 20,000.00 | \$ 20,000.00 |
| (b) City of London | 11-8-25 | 11-8-25 | \$ 22,000.00 | | \$ 98,000.00 | \$ 76,000.00 |
| (c) A Corp. stock | 8-10-28 | 8-10-28 | \$ 27,833.33 | | \$ 28,000.00 | \$ 221.67 |
| (d) Land | 1-2-29 | 1-2-29 | \$ 27,833.33 | | \$ 28,000.00 | \$ 221.67 |
| Total net long-term capital gain (or loss) (Enter as item 11 (c) page 1) | | | | | \$ 18,221.67 | \$ 18,221.67 |

| Schedule D—GAINS AND LOSSES FROM SALES OR EXCHANGES OF PROPERTY OTHER THAN CAPITAL ASSETS (See Instruction 20) | | | | | | |
|--|------------------|--|------------------------|--|---|---|
| 1. Description of Property | 2. Date Acquired | 3. Date Sold or Disposed of (Contract price) | 4. Cost or Other Basis | 5. Depreciation Allowed (See Instructions 20 and 21) | 6. Gain or Loss (Enter as item 5, page 1) | 7. Gain or Loss (Enter as item 5, page 1) |
| (a) Buildings | 1-2-30 | 1-2-30 | \$ 59,166.87 | | \$ 185,000.00 | \$ 125,833.13 |
| (b) Machinery | 1-2-36 | 1-2-36 | \$ 1,500.00 | | \$ 23,000.00 | \$ 21,500.00 |
| Total net gain (or loss) (Enter as item 11 (c) page 1) | | | | | \$ 148,833.13 | \$ 148,833.13 |

Supplemental information required for Schedules C and D

State with respect to each item of property reported in Schedule C and D (1) low property was acquired (2) whether at time of sale or exchange (3) purchase price (4) or indirectly from more than 50 percent in value of your outstanding stock (5) where purchase was a corporate one, the stock was owned by more than 50 percent in value of your capital stock was owned directly or indirectly by the same individual or his family, and (c) where the purchaser was a corporation, whether more than 50 percent in value of the capital stock was owned directly or indirectly by you

If so state name and address of purchaser

1 (continued). Federal Corporation Income and Declared Value Excess-Profits Tax Return

| Schedule E—INCOME FROM DIVIDENDS | | | | | | Page 9 |
|--|---|------------------------|----------------------|--|--|--------------------|
| 1. Name and Address of Paying Corporation | 2. Domestic Corporation's Taxable Year (Check 1) (Federal Revenue Code) | 3. Foreign Corporation | 4. Other Corporation | | | |
| W. Corporation, Syracuse, N. Y. | \$ 2,400.00 | | | | | |
| Briggs & Co., Ltd., London, England | | 700.00 | | | | |
| Total | \$ 2,400.00 | \$ 700.00 | | | | |
| Total of columns 2, 3, and 4 (Enter as item 12 page 1) | | | | | | \$ 3,100.00 |

Report dividends received from corporations organized under the China Trade Act, 1922, and corporations entitled to the benefits of section 231 of the Federal Revenue Code which dividends should be reported in column 4.

| Schedule F—COMPENSATION OF OFFICERS | | | | | |
|--|-------------------|-----------------------------|-----------------|----------------|---------------------------|
| 1. Name and Address of Officer | 2. Official Title | 3. Time Devoted to Business | 4. Compensation | 5. Perquisites | 6. Amount of Compensation |
| Walter Chase, 9173 N. State St., Chicago, Ill. | President | all | 20% | | \$ 22,000.00 |
| Herbert Austin | Secretary | all | 10% | | 10,000.00 |
| James Smith | Treasurer | all | 15% | | 24,000.00 |
| Total compensation of officers (Enter as item 15 page 1) | | | | | \$ 60,000.00 |

Note—Schedule F-1 (IN DUPLICATE) also must be filed with this return if compensation in excess of \$75,000 was paid to any officer or employee.

| Schedule G—BAD DEBTS (See Instruction 23) (See note 1) | | | | | |
|--|------------------------|---------------------|---|----------------------------------|-----------------------------------|
| 1. Taxable Year | 2. Net Income Reported | 3. Sales on Account | 4. Bad Debts Charged Off by Corporation or No. Returned to Creditors (See note 2) | 5. Gross Amount Added to Reserve | 6. Amount Charged Against Reserve |
| 1936 | \$ 21,580.00 | \$ 288,000.00 | | \$ 3,000.00 | \$ 2,855.57 |
| 1937 | 60,380.00 | 780,000.00 | | 9,745.00 | 6,080.68 |
| 1938 (See note 2) | 75,254.50 | 1,080,000.00 | | 11,554.60 | 9,645.00 |
| 1939 (See note 2) Loss | 47,831.18 | 1,130,000.00 | | 11,184.00 | 9,275.50 |
| 1940 (See note 2) | 145,087.28 | 1,398,800.00 | | 12,514.40 | 14,679.99 |

1. Check whether deduction claimed represents worthless debts charged off ☐, or is an addition to a reserve ☒.
2. Not including securities which are capital assets ascertained to be worthless and charged off within the taxable year. Such securities charged off within the year covered by this return should be reported in Schedule C.

| Schedule H—TAXES (See Instruction 25) | | Schedule I—CONTRIBUTIONS OR GIFTS PAID (See Instruction 26) | |
|--|---------------------|---|------------------|
| Name | Amount | Name and Address of Organization | Amount |
| Real estate, City of Chicago | \$ 6,611.62 | American Red Cross, Chicago, Ill. | \$ 600.00 |
| Unemploy't ins., old-age benefit | 17,960.00 | | |
| Federal capital stock tax | 2,165.00 | | |
| Federal stamp taxes | 236.00 | | |
| Interest and maintenance charges | 1 | | |
| Special assessment taxes | 180.00 | | |
| Illinois franchise tax | 8,982.68 | | |
| Auto licenses | 500.00 | | |
| Total (Enter as item 21 page 1) | \$ 32,594.30 | Total (Enter as item 24, page 1, subject to 5 percent limitation) (See Instruction 26) | \$ 600.00 |

| Schedule J—DEPRECIATION (See Instruction 28) | | | | | | | | |
|---|------------------|---|--|---|--|---------------------------------------|---|-------------------------------------|
| 1. Kind of property (If buildings, state material of which constructed) | 2. Date Acquired | 3. Cost or Other Basis (Cost not including land or other nondepreciable property) | 4. Asset Fully Depreciated (Use 1st End of Year) | 5. Depreciation Allowed for Prior Years | 6. Remaining Cost or Other Basis to be Depreciated | 7. Rate Applied (Use 1st End of Year) | 8. Depreciation Allowed for Current Year (Life From Depreciation Table) | 9. Depreciation Allowable This Year |
| Buildings, brick | 3-1-28 | 106,000.00 | None | \$1,580.00 | \$14,640.00 | 4% | 28 1/8 | \$ 2,855.57 |
| Buildings, steel | 3-1-27 | 494,400.00 | None | 29,644.00 | 464,756.00 | 5% | 47 | 23,989.80 |
| Machinery | 3-1-28 | 282,000.00 | None | 50,400.00 | 231,600.00 | 10 | 8 | 23,200.00 |
| Auto trucks | 4-1-40 | 21,000.00 | None | None | 21,000.00 | 5 | 5 | 5,150.00 |
| Furniture and fixtures | 3-1-28 | 21,600.00 | None | 4,320.00 | 17,280.00 | 10 | 8 | 2,160.00 |
| Patents | 3-1-27 | 144,000.00 | None | 36,000.00 | 108,000.00 | 12 | 9 | 12,000.00 |
| Total (Enter as item 34 page 1) | | | | | | | | \$ 68,045.37 |

| Schedule K—OTHER DEDUCTIONS (See Instruction 32) | |
|--|--------|
| Name | Amount |
| See Schedule attached. | |

| QUESTIONS | |
|---|-------------------|
| 1. Date of incorporation | 1924 |
| 2. State of incorporation | Illinois |
| 3. Principal office | Chicago, Illinois |
| 4. Principal business | Manufacturing |
| 5. Number of places of business | One |
| 6. Was the corporation during the taxable year engaged in the production of facilities for national defense through Government contracts or subcontracts? | Yes |
| 7. Is the corporation a personal holding company within the meaning of section 501 of the Federal Revenue Code? | No |
| 8. Is this a consolidated return of railroad corporations or Pan American trade corporation? | No |
| 9. Did the corporation make a return of information on Form 1090 and 1099 for the calendar year 1940 (see Instruction 8-11)? | Yes |
| 10. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? (Answer "yes" or "no") | No |
| 11. State whether the inventories at the beginning and end of the taxable year were valued at cost, or cost or market, whichever is lower | Cost or market |
| 12. Did the corporation make a return of information on Forms 1090 and 1099 for the calendar year 1940 (see Instruction 8-11)? | Yes |
| 13. Did the corporation at any time during the taxable year own directly or indirectly any stock of a foreign corporation? (Answer "yes" or "no") | No |

1 (concluded). Federal Corporation Income and Declared Value Excess-Profits Tax Return

| Schedule L—BALANCE SHEETS. (See Instruction 13) | | | | Page 4 | |
|---|-------------------------------|---------------------------|-----------------|---------------------|-----------------|
| | | Beginning of Taxable Year | | End of Taxable Year | |
| ASSETS | | Amount | Total | Amount | Total |
| 1. Cash | | \$ 154,820.61 | \$ 49,796.53 | \$ 131,164.76 | \$ 82,348.21 |
| 2. Notes and accounts receivable | | 16,482.06 | 139,338.68 | 13,116.48 | 118,048.28 |
| 3. Inventories (Itemize) | | | 182,364.90 | | 178,279.58 |
| 4. Investments (Government obligations) | | | | | |
| (a) State, Territory, or political subdivision thereof, or the District of Columbia, or United States possessions | | \$ 148,800.00 | | \$ 60,000.00 | |
| (b) United States | | 102,500.00 | | 102,500.00 | |
| (c) Instrumentalities of the United States | | | 251,100.00 | | 182,500.00 |
| 5. Other investments (Itemize) | Stocks | \$ 30,000.00 | | \$ 10,000.00 | |
| | Bonds | 26,000.00 | | | 10,000.00 |
| 6. Capital assets | | 728,400.00 | | 600,400.00 | |
| (a) Depreciable assets (Itemize) | Buildings | \$ 278,000.00 | | \$ 285,000.00 | |
| | Machinery & Equipment | 21,000.00 | | 49,000.00 | |
| | Furniture & Fixtures | 21,000.00 | | | |
| | Tools | 21,000.00 | | | |
| | Other | 21,000.00 | | | |
| | Total depreciable | 341,000.00 | | 384,000.00 | |
| | Less Reserve for depreciation | | | | |
| (b) Depletable assets (Itemize) | | | | | |
| (c) Land | | | 118,000.00 | | 174,000.00 |
| 7. Other assets (Itemize) | | | | | |
| 8. TOTAL ASSETS | | \$ 1,000,000.00 | \$ 1,000,000.00 | \$ 1,000,000.00 | \$ 1,000,000.00 |
| LIABILITIES | | | | | |
| 9. Accounts payable | | | \$ 180,427.69 | | \$ 136,575.37 |
| 10. Bonds, notes, and mortgages payable | | | | | |
| (a) With original maturity of less than 1 year | | \$ 2,000.00 | | | |
| (b) With original maturity of 1 year or more | | 225,000.00 | | 275,000.00 | |
| 11. Accrued expenses (Itemize) | | | | | |
| Salaries, wages, interest, taxes, etc. | | 60,032.60 | | 100,940.00 | |
| 12. Other liabilities (Itemize) | | | | | |
| Federal income tax | | | | 35,008.42 | |
| 13. Surplus reserves (Itemize) | | | | | |
| Surplus reserves | | 3,800.00 | | 3,800.00 | |
| 14. Capital stock | | | | | |
| (a) Preferred stock | | \$ 400,000.00 | | | |
| (b) Common stock | | 700,000.00 | | 825,000.00 | |
| 15. Paid in or capital surplus | | | | | |
| 16. Earned surplus and undivided profits | | | 254,796.59 | | 294,524.98 |
| 17. TOTAL LIABILITIES | | | \$ 1,000,000.00 | | \$ 1,000,000.00 |

| Schedule M—RECONCILIATION OF NET INCOME AND ANALYSIS OF EARNED SURPLUS AND UNDIVIDED PROFITS | | | |
|--|--|---------------|--|
| 1. Total distributions to stockholders charged to earned surplus during the taxable year | | \$ 50,000.00 | |
| (a) Cash | | | |
| (b) Stock of the corporation | | 25,000.00 | |
| (c) Other property | | | |
| 2. Contributions (excess over 5 percent limit) | | | |
| 3. Excess of short-term capital losses over short-term capital gains | | 4,000.00 | |
| 4. Additions to surplus reserves (Net separately) | | | |
| (a) Reserve for pensions | | 1,000.00 | |
| (b) Anticipated repairs | | 2,500.00 | |
| 5. Other allowable deductions (land & bligs.) | | | |
| (a) Improvements & alterations | | 3,700.00 | |
| (b) Tax on land purchased | | 500.00 | |
| 6. Adjustments not recorded on books (Itemize) | | | |
| (a) | | 1,620.00 | |
| (b) | | | |
| 7. Sundry debits to earned surplus (Itemize) | | | |
| (a) | | | |
| (b) | | | |
| 8. Earned surplus and undivided profits at close of the taxable year (Schedule L) | | 294,524.98 | |
| 9. Total of lines 1 to 8 | | \$ 419,208.53 | |
| 10. Earned surplus and undivided profits at close of preceding taxable year (Schedule L) | | 254,796.59 | |
| 11. Adjusted net income (Item 84, page 1) | | 131,137.29 | |
| 12. Nontaxable and partially exempt income | | | |
| (a) Interest on | | | |
| (b) Obligations of a State, Territory, or political subdivision thereof, or the District of Columbia | | | |
| (c) United States savings bonds and Treasury bonds owned in the principal amount of over \$5,000 | | | |
| (d) Obligations of instrumentalities of the United States | | | |
| (e) Other nontaxable income (Itemize) | | | |
| 13. Charges against surplus reserves (Itemize) | | | |
| (a) | | | |
| (b) | | | |
| 14. Adjustments not recorded on books (Itemize) | | | |
| (a) Net operating loss, due to | | | |
| (b) Deduction for 1933 | | 10,884.48 | |
| 15. Sundry credits to earned surplus (Itemize) | | | |
| (a) | | | |
| (b) | | | |
| 16. Total of lines 1 to 15 | | \$ 419,208.53 | |

EXCESS PROFITS TAX (Second Revenue Act of 1940) (See Instructions for Form 112)

(a) Is an excess profits tax return on Form 112 being filed for the taxable year covered by this return?

(b) A corporation which has not elected to be treated as a corporation for the purpose of the excess profits tax is not required to file this return.

(c) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(d) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(e) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(f) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(g) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(h) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(i) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(j) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(k) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(l) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(m) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(n) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(o) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(p) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(q) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(r) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(s) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(t) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(u) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(v) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(w) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(x) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(y) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

(z) If a corporation has elected to be treated as a corporation for the purpose of the excess profits tax, it shall compute its excess profits tax on the basis of the net income computed under the method prescribed in Section 504 of the Internal Revenue Code, and shall file this return with the excess profits tax return for the taxable year of the corporation.

2. Federal Excess Profits Tax Return

| Form 1122—(Revised March 1941) Treasury Department Internal Revenue Service (Taxpayer's name) | | UNITED STATES CORPORATION EXCESS PROFITS TAX RETURN For Calendar Year 1940 or fiscal year beginning _____, 1940, and ended _____, 1941 <small>PRINT PLAINLY CORPORATION'S NAME AND ADDRESS</small> | | 1940 File Code _____ Serial No. _____ District _____ (Collector's name) _____ Cath. Check No. _____ First of month _____ |
|---|---|---|---------------------|--|
| X. Y. Z. Corporation (Name) | | 9175 N. State Street (General address) | | |
| Chicago (City and State) | | Cook (County) | Illinois (State) | |
| Business group serial number entered on page 1 Form 1120 _____ | | | | |
| (a) Date of incorporation <u>March 1924</u> (b) State or country <u>Illinois</u> (c) Collector's office in which your income tax return for the taxable year was filed <u>1st District, Illinois</u> (d) Is this a consolidated return? <u>No</u> If so, procure from the collector Form 851E, Affiliations Schedule which shall be filed in sworn to and filed as a part of this return (e) In computing the excess profits credit under the invested capital method do you elect to include in excess profits net income interest received on government obligations specified in section 22 (b) (4) of the Internal Revenue Code? <u>No</u> (f) Do you elect in this return to capitalize expenditures for advertising or promotion of good will as provided in section 733 of the Internal Revenue Code (see instruction VI)? <u>No</u> (g) Are you an acquiring corporation of a qualified component corporation as defined in section 740 of the Internal Revenue Code? <u>No</u> If so and if you were actually in existence before January 1, 1940 do you elect to compute the average base period net income under the method prescribed in section 742 in lieu of the method prescribed in section 737? <u>No</u> (h) Are you a transferee or transferee upon an exchange (as defined by section 750 of the Internal Revenue Code) which occurred in a taxable year beginning after December 31, 1939? <u>No</u> | | | | |
| SPECIFIC DISCLAIMER | | | | |
| Unless you specifically disclaim in (1) or (2) below either the credit computed under the income method or the credit computed under the invested capital method it is mandatory that both Schedules I and II and both Schedules A and B be completed before this form will be considered as a return. (The foregoing is applicable only to a corporation in existence prior to January 1, 1940. If you are a foreign corporation, see the Instructions.) For effect of disclaimer see Instructions V and V-a. (1) Do you disclaim the use of the credit computed under section 713—the income method? <u>Yes</u> (2) Do you disclaim the use of the credit computed under section 714—the invested capital method? <u>Yes</u> IF YOU HAVE NOT DISCLAIMED ONE METHOD SCHEDULES I, II, A, AND B MUST BE COMPLETED | | | | |
| EXCESS PROFITS NET INCOME COMPUTATION (See instruction III) | | | | |
| Item No. | SCHEDULE I EXCESS PROFITS CREDIT BASED ON INCOME | | | |
| 1 | Normal tax net income (item 36 page 1, Form 1120) | | \$ 139,097 | 29 |
| 2 | Add Net long term capital LOSS (item 11 (b) page 1 Form 1120) | | 19,765 | 87 |
| 3 | Total of items 1 and 2 | | \$ 158,862 | 98 |
| 4 | Less Income and Income Defense Taxes (item 39 page 1 Form 1120) | \$ 33,363 | 58 | |
| 5 | Net long term capital GAIN (item 11 (b) page 1 Form 1120) | | | |
| 6 | Net GAIN from sale or exchange of depreciable property held more than 18 months | | | |
| 7 | Income from retirement or discharge of bonds, etc. | 5,000 | 00 | |
| 8 | Refunds and interest on Agricultural Adjustment Act taxes | | | |
| 9 | Recoveries of bad debts | 500 | 00 | |
| 10 | Dividends received credit adjustment (total of columns 2 and 4 Schedule E Form 1120) | 860 | 00 | |
| 11 | Total | | \$ 9,045 | 55 |
| 12 | Excess profits net income computed under income credit method (item 3 minus item 12) | | \$ 149,817 | 61 |
| SCHEDULE II EXCESS PROFITS CREDIT BASED ON INVESTED CAPITAL | | | | |
| 13 | Amount of item 13 | | \$ 118,820 | 61 |
| 14 | Add 50 percent of interest on borrowed capital | | 5,419 | 98 |
| 15 | Interest on government obligations. (See Question (c) above for election) | | 5,390 | 00 |
| 16 | Total of items 14 to 16 | | \$ 129,629 | 59 |
| 17 | Less Dividends received credit adjustment (total of columns 3 Schedule E Form 1120 excluding dividends (actual or constructive) on stock of foreign parent holding companies) | | 700 | 00 |
| 18 | Excess profits net income computed under invested capital credit method (item 17 minus item 18) | | \$ 132,530 | 59 |
| EXCESS PROFITS TAX COMPUTATION | | | | |
| 20 | Excess profits net income (item 12 or item 18, whichever is applicable) | Column 1 | Column 2 | Column 3 |
| 21 | Less Specific exemption | \$ 5,000 | 00 | |
| 22 | Adjusted net income | \$ 127,530 | 59 | |
| 23 | Portion of item 22 (not in excess of \$20,000) and tax at 25 percent | \$ 3,188 | 25 | \$ 4,291 |
| 24 | Portion of item 22 (in excess of \$20,000 and not in excess of \$50,000) and tax at 30 percent | | 30 | |
| 25 | Portion of item 22 (in excess of \$50,000 and not in excess of \$100,000) and tax at 35 percent | | 35 | |
| 26 | Portion of item 22 (in excess of \$100,000 and not in excess of \$250,000) and tax at 40 percent | | 40 | |
| 27 | Portion of item 22 (in excess of \$250,000 and not in excess of \$500,000) and tax at 45 percent | | 45 | |
| 28 | Portion of item 22 (in excess of \$500,000) and tax at 50 percent | | 50 | |
| 29 | Total excess profits tax (item 20 plus line 31) | | | \$ 4,291 |
| 30 | Less Credit for income taxes paid to a foreign country or United States possession allowed to a domestic corporation not used in computing item 38, page 1, Form 1120 | | | |
| 31 | Balance of excess profits tax due | | | \$ 4,291 |
| We, the undersigned, president (or vice president or other principal officer) and treasurer (or assistant treasurer or chief accounting officer) of the corporation for the taxable year, do hereby certify that the return (including any accompanying schedules and statements) has been examined by him and is to the best of his knowledge and belief, a true, correct, and complete return, made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder. Subscribed and sworn to before me this <u>27th</u> day of <u>January</u> , 1941. <div style="display: flex; justify-content: space-between;"> <div> Notary Public <u>Frank A. Jones</u> <small>(State of Illinois)</small> </div> <div> Notary Public <u>James Smith</u> <small>(State of Illinois)</small> </div> </div> <p> If we (or affirm) that I, appeared before me for purposes of filing this return and certifying my profit per year and net income and balance of excess profits tax, as a result of my examination of the return and the statements and schedules, I am satisfied that the return is true and correct, and I am satisfied that the return is made in good faith, for the taxable year stated, pursuant to the Internal Revenue Code and the regulations issued thereunder. Subscribed and sworn to before me this <u>27th</u> day of <u>January</u>, 1941. <div style="display: flex; justify-content: space-between;"> <div> Notary Public <u>Albert Brown</u> <small>(State of Illinois)</small> </div> <div> Notary Public <u>William H. Brown</u> <small>(State of Illinois)</small> </div> </div> </p> | | | | |

2 (concluded). Federal Excess Profits Tax Return

| Schedule A—EXCESS PROFITS CREDIT—BASED ON INCOME (See Instruction VI) | | | | |
|--|---------------|---------------|---------------|---------------|
| TAXABLE YEARS BEGINNING AFTER DECEMBER 31, 1941 AND BEFORE JANUARY 1, 1942 (If additional credits for taxable years ending before 1942 are shown) | | | | |
| | 1. Year Ended | 2. Year Ended | 3. Year Ended | 4. Year Ended |
| | 1942 | 1943 | 1944 | 1945 |
| 1 Normal-tax (or special-class) net income | | | | |
| 2 (a) Net capital gain used in computing line 1 | | | | |
| 3 (b) Net capital loss used in computing line 1 | | | | |
| 4 Difference between lines 1 and 2(a) (if a net capital gain) or total of lines 1 and 2(b) (if a net capital loss) | | | | |
| 5 Add Securities which are capital assets deducted in computing line 1 as bad debts or as assets determined to be worth less (for taxable years beginning prior to January 1, 1938) | | | | |
| 6 Net short-term capital gain | | | | |
| 7 Net long-term capital gain | | | | |
| 8 Net gain from sale or exchange of property other than capital assets (for taxable years beginning prior to January 1, 1938) | | | | |
| 9 Total of lines 5 to 8 | | | | |
| 10 Less Net long-term capital loss | | | | |
| 11 Net loss from sale or exchange of property other than capital assets (for taxable years beginning prior to January 1, 1938) | | | | |
| 12 Total of lines 9 and 10 | | | | |
| 13 Normal tax (or special-class) net income (after applying section 711(b)(2)) (line 5 minus line 12) | | | | |
| 14 Add Dividends received credit. (See line 23, below) | | | | |
| 15 Deductions on account of retirement or discharge of bonds, etc. | | | | |
| 16 Casualty, demolition and similar losses | | | | |
| 17 Repayment of processing tax to vendee | | | | |
| 18 (a) Abnormal judgment liabilities, etc. (attach statement) | | | | |
| 19 (b) Abnormal expenditures for intangible drilling and development costs (attach statement) | | | | |
| 20 (c) Other abnormal deductions (attach statement) | | | | |
| 21 Capitalization of expenditures for advertising or promotion of good will (attach statement) | | | | |
| 22 Net long-term capital loss (See line 9, above) | | | | |
| 23 Total of lines 13 to 22 | | | | |
| 24 Less Income taxes | | | | |
| 25 Income from retirement or discharge of bonds, etc. | | | | |
| 26 Dividends received from domestic corporations | | | | |
| 27 Net long-term capital gain (See line 6, above) | | | | |
| 28 Net gain from sale or exchange of depreciable property held for more than 18 months | | | | |
| 29 Total of lines 21 to 28 | | | | |
| 30 Excess profits net income (line 20 minus line 29) | | | | |
| 31 Net aggregate of columns 1, 2, 3 and 4 (see Instruction VI for computation of deficit in excess profits net income and substitution of zero for largest deficit figure. Attach schedule showing detailed computation) | | | | |
| 32 Excess of line 30 over line 31 | | | | |
| 33 One-half of line 32 | | | | |
| 34 Line 30 plus line 33 | | | | |
| 35 8 percent of line 34 if a net capital addition (or 6 percent of line 34 if a net capital reduction) | | | | |
| 36 Excess profits credit—based on income (line 37 plus line 35 if a net capital addition) (or line 37 minus line 35 if a net capital reduction) | | | | |

| Schedule B—EXCESS PROFITS CREDIT—BASED ON INVESTED CAPITAL (See Instruction VII) | |
|---|-----------------|
| Equity Invested Capital at the Beginning of the Taxable Year | |
| 1 Money paid in for stock, or as paid in surplus, or as a contribution to capital | \$ 841,000.00 |
| 2 Property paid in for stock, or as paid in surplus, or as a contribution to capital | \$ 820,000.00 |
| 3 Distributions of earnings and profits in stock of the corporation | \$ 80,000.00 |
| 4 Accumulated earnings and profits | \$ 387,417.78 |
| 5 Increase on account of gain on tax free liquidation | |
| 6 Total of lines 1 to 5 | \$ 2,028,417.78 |
| 7 Less Distributions made prior to the taxable year out of accumulated earnings and profits | \$ 1,185,000.00 |
| 8 Earnings and profits of another corporation if included in line 4, above | |
| 9 Reduction on account of loss on tax free liquidation (not in excess of line 4) | |
| 10 Total of lines 7 to 9 | \$ 155,000.00 |
| 11 Equity invested capital at beginning of taxable year (line 6 minus line 10) | \$ 1,873,417.78 |
| Average Addition to Equity Invested Capital During the Taxable Year | |
| 12 Money paid in for stock, or as paid in surplus, or as a contribution to capital | \$ 68,868.67 |
| 13 Property paid in for stock, or as paid in surplus, or as a contribution to capital | |
| 14 Distributions of earnings and profits in stock of the corporation | |
| 15 Increase on account of gain on tax free liquidation | |
| 16 Total of lines 12 to 15 | \$ 68,868.67 |
| 17 Total of lines 11 and 16 | \$ 1,942,286.45 |
| Average Deduction in Equity Invested Capital During the Taxable Year | |
| 18 Distributions made prior to the taxable year out of accumulated earnings and profits | \$ 135,355.33 |
| 19 Excess distribution as from accumulated earnings and profits | |
| 20 Reduction on account of loss on tax free liquidation (not in excess of line 14, above) | |
| 21 Total of lines 18 to 20 | \$ 135,355.33 |
| 22 Average equity invested capital (line 17 minus line 21) | \$ 1,806,931.12 |
| 23 Average borrowed capital (assets minus liabilities) | \$ 276,551.97 |
| 24 Average borrowed invested capital (50 percent of line 23) | \$ 138,275.99 |
| 25 Average invested capital (line 22 plus line 24) | \$ 1,945,207.11 |
| 26 Total inadmissible assets | \$ 80,800.00 |
| 27 Total inadmissible and inadmissible assets | \$ 1,764,397.11 |
| 28 Portion of line 25 in excess of line 27 | \$ 180,810.00 |
| 29 Reduction on account of inadmissible assets (50 percent of line 28) | \$ 90,405.00 |
| 30 Invested capital (line 25 minus line 29) | \$ 1,853,792.11 |
| 31 Excess profits credit—based on invested capital (line 30 plus line 35 if a net capital addition) (or line 30 minus line 35 if a net capital reduction) | \$ 1,853,792.11 |

3. Federal Capital Stock Tax Return

| | | |
|---|--|--|
| <p>(FOR WASHINGTON USE ONLY) (FOR USE OF COLLECTORS)</p> <p>(Collection district) _____</p> <p>(Month) _____ (Year) _____</p> <p>(Page) _____ (Line) _____</p> | <h2 style="margin: 0;">1941 RETURN</h2> <p style="margin: 0;">OF CAPITAL-STOCK TAX</p> <p style="margin: 0;">For Year Ending June 30, 1941</p> <p style="margin: 0;">DOMESTIC CORPORATIONS (Chapter 6, Internal Revenue Code as amended)</p> <p style="margin: 0; font-size: small;">This return must be filed, in triplicate, and received with remittance by the Collector for your district on or before July 31, 1941 (See Instruction 7, page 8)</p> | <p style="text-align: right; font-size: small;">Form 707 TREASURY DEPARTMENT INTERNAL REVENUE SERVICE</p> <p style="text-align: right; font-size: small;">(To be stamped above by Collector, showing district and date received)</p> |
| <p>1 Name <u>I. Y. Z. Corporation</u> (Print name of corporation, joint-stock company, or association)</p> <p>2 Address <u>9173 N. State Street, Chicago, Illinois</u> (The address must be that of the principal place of business. Give street and number, city or town, and "State")</p> <p>3 Incorporated or organized in State of <u>Illinois</u> Month <u>March</u> Day <u>10</u> Year <u>1908</u></p> <p>4 Was a 1940 capital-stock tax return filed? <u>Yes</u> Name under which filed (If different, attach statement explaining fully) _____ (District _____)</p> <p>5 Date of close of last income-tax year ended prior to July 1, 1941 <u>December 31, 1940</u> Was an income-tax return filed for that year? <u>Yes</u> Name under which filed <u>I. Y. Z. Corporation</u> (District _____)</p> <p>If the corporation is newly organized and has not established an income-tax year, state date of organization _____</p> <p>6 Nature of business in detail <u>Manufacturer of household goods</u></p> <p>7 Name of parent company, if any _____ (District _____)</p> <p>8 Name of subsidiary, if any _____ No shares held _____ (District _____) (If more than one, attach list and state number of shares held by parent also districts where filed)</p> | | |
| <p>9 DECLARED VALUE OF ENTIRE CAPITAL STOCK \$ <u>1,800,000</u> (The value declared must be definite and unqualified. A value must be declared in every case regardless of whether exemption is claimed. See Instructions 1 and 2)</p> | | |
| <p>10 EXEMPTIONS — <u>1</u> Corporations claiming exemption from section 10 showing the basis of</p> <p><input type="checkbox"/> Corporation exempt from income tax under section 101, Internal Revenue Code. Furnish information required by Instruction 4.</p> <p><input type="checkbox"/> Insurance company subject to tax under section 201, 204, or 207, Internal Revenue Code. State which section _____</p> <p><input type="checkbox"/> Corporation not doing business. Furnish information required by instruction 6</p> <p style="text-align: right; font-size: small;">16-21334</p> | | |
| COMPUTATION OF TAX | FOR USE OF TAXPAYER | FOR USE OF DEPARTMENT |
| 11 Declared value (must be identical figure entered in item 9). | \$ <u>1</u> <u>800</u> <u>000</u> | \$ _____ |
| 12 Tax at rate of \$1 10 for each full \$1,000 in item 9. | _____ <u>1</u> <u>980</u> | _____ |
| 13 Penalty of _____ percent for delinquency in filing return. | _____ | _____ |
| 14 Interest at 6 percent per annum beginning Aug 1, 1941 | _____ | _____ |
| 15 Total tax, penalty, and interest | \$ _____ <u>1</u> <u>980</u> | \$ _____ |
| 16 State amounts of outstanding capital stock and surplus as of date of the close of income-tax taxable year reported in item 5 above (If nonstock organization, so indicate and attach statement of net worth) | | |
| | NUMBER OF SHARES | PAR (STATED) VALUE PER SHARE |
| Capital stock Preferred. | 6,000 | \$100 |
| Common. | 6,000 | 100 |
| Capital or paid in surplus. | x x x x x x x x x x | x x x x x x x x x x |
| Surplus reserves | x x x x x x x x x x | x x x x x x x x x x |
| Surplus and undivided profits | x x x x x x x x x x | x x x x x x x x x x |
| We, the undersigned _____ <u>William F. Brown</u> _____, President (Print plainly name of president, vice president, or other principal officer) | | (Title) |
| and _____ <u>John B. Smith</u> _____, Treasurer (Print plainly name of treasurer, assistant treasurer, or chief accounting officer) | | (Title) |
| return is made, being severally duly sworn, each for himself deposes and says that this return, including any accompanying schedules and statements, has been examined by him and is, to the best of his knowledge and belief, a true and complete return, made in good faith, for the taxable year stated, pursuant to Chapter 6, Internal Revenue Code, and Regulations 64 (1938 edition), as amended, made applicable to the Internal Revenue Code by Treasury Decision 4885, approved February 11, 1939 | | |
| Sworn to and subscribed before me this <u>28th</u> day of <u>July</u> , 19 <u>41</u> | | |
| <p>NOTARIAL SEAL</p> <p><u>Georget Black</u> (Signature of officer administering oath)</p> <p>Notary Public (Official capacity)</p> | <p>CORPORATE SEAL</p> <p><u>William F. Brown</u> _____ President (Signature) (Title)</p> <p><u>John B. Smith</u> _____ Treasurer (Signature) (Title)</p> | <p>PAGE _____</p> <p style="font-size: small;">16-21334 U. S. GOVERNMENT PRINTING OFFICE</p> |

4. State Corporation Income Tax Return

| | | |
|---|--|---|
| <p>RCGN 1-1403M-1-40</p> <p>IMPORTANT</p> <p>THIS REPORT IS DUE ON OR BEFORE APRIL 15, 1941 OR IN CASE OF COMPANIES REPORTING ON A FISCAL YEAR BASIS WITHIN 30 DAYS AFTER THE INCOME TAX RETURN TO THE FEDERAL GOVERNMENT IS DUE.</p> <p>COMPLETE INSTRUCTIONS FOR THE PREPARATION OF THIS REPORT WILL BE FOUND IN THE REGULATIONS ISSUED BY THE DEPARTMENT OF REVENUE.</p> | <p>COMMONWEALTH OF PENNSYLVANIA CORPORATE NET INCOME TAX REPORT For Calendar Year 1940</p> <p>or Fiscal Year began 1940, ended 1941 (Act of May 16, 1935, P. L. 208, as Amended)</p> <p>(PRINT PLAINLY BELOW NAME AND BUSINESS ADDRESS)</p> <p>X Foreign Manufacturing Company (Name)</p> <p>1999 Fourth Avenue (Number and Street)</p> <p>New York, N. Y. (Post Office and State)</p> <p>Date of Incorporation February 1st, 1935 (Date of State or Country)</p> <p>Under the Laws of New York (Name of State or Country)</p> | <p style="text-align: right;">Page 1</p> <p>PAYMENT OF TAX</p> <p>PAYMENT OF NOT LESS THAN ONE-HALF OF TAX MUST BE MADE WHEN THIS REPORT IS DUE. BALANCE OF TAX IS PAYABLE WITHIN 30 DAYS AFTER THIS REPORT IS DUE.</p> <p>FILL IN TRANSMITTAL SLIP</p> <p>ATTACH REMITTANCE TO THE ORDER OF THE COMMONWEALTH OF PENNSYLVANIA</p> <p>FILE THIS REPORT WITH PENNSYLVANIA DEPARTMENT OF REVENUE HARRISBURG, PENNSYLVANIA</p> |
| <p>COMPUTATION OF TAX</p> | | |
| <p>1 Adjusted Net Income (as shown in Exhibit I, Item 34 on Page 2)</p> <p>2 Taxes paid to Federal Government and not included in Exhibit I, (As per Schedule J) (Do not include excess profits tax—See Item 31, Exhibit I)</p> <p>3 Dividends received from Corporations (Exhibit I, Item 12)</p> <p>4 Item 1 less sum of Item 2 + 3 =</p> <p>5 Tax (7% of Item 4)—(Leave blank if entire business is not transacted in Penna.)</p> <p>WHERE ENTIRE BUSINESS IS NOT TRANSACTED IN PENNSYLVANIA, COMPLETE THIS SCHEDULE</p> <p>6 Deduct gain from sale of TANGIBLE capital assets</p> <p>(as per Schedule C) situated: Outside Penna.</p> <p>In Penna.</p> | | <p>88,919 80</p> <p>16,703 79</p> <p>800 00</p> <p>77,503 79</p> <p>71,416 01</p> <p>500 00</p> <p>70,916 01</p> <p>274802</p> <p>19,497 86</p> <p>500 00</p> <p>19,997 86</p> <p>1,999 15</p> |
| <p>DETERMINATION OF ALLOCATING PERCENTAGE</p> | | |
| <p>Divide (a) by (b) to obtain decimal—carry out decimal at least six places</p> | | |
| <p>1 (a) Average value of tangible property in Pennsylvania</p> <p>(b) Average value of all tangible property</p> | | <p>325,000</p> <p>1,000,000</p> <p>.325</p> |
| <p>2 (a) Wages, salaries, etc. assignable to Pennsylvania</p> <p>(b) Total wages, salaries, etc.</p> | | <p>111,444 75</p> <p>495,310 00</p> <p>.225</p> |
| <p>3 (a) Gross receipts assignable to Pennsylvania</p> <p>(b) Gross receipts from all business</p> | | <p>380,572 50</p> <p>1,386,720 00</p> <p>.274407</p> |
| <p>4 Total of Items 1, 2 and 3—Divide by "three"</p> <p>5 Allocating percentage (Express in Decimal)</p> <p>* If only two of above proportions apply divide by 2 if only one of the above proportions applies, divide by 1</p> | | <p>.324407</p> <p>.274802</p> |
| <p>AFFIDAVIT</p> | | |
| <p>We, the officers of the corporation for which this report is made, being severally sworn, (or affirmed), each for himself, depose and says that this report including the accompanying schedules and statements, have been examined by him and is to the best of his knowledge and belief a true and complete report made in good faith for the taxable period as stated, that the items as herein set forth, unless otherwise provided by the Pennsylvania Department of Revenue are a true copy of such items as were included in the last return made to the Collector of Internal Revenue of the United States, and that no office warehouse or other place of business is or has been maintained in a state other than this Commonwealth for the purpose of reducing the amount of taxes to be paid by said corporation</p> | | |
| <p>Sworn to (or affirmed) and subscribed before me this 20th day of February 1941</p> <p>Notary Public</p> | | |
| <p>CERTIFICATION (As to preparation of Report)</p> | | |
| <p>I/we certify that I/we prepared this report for the corporation named herein and that the report (including its accompanying schedules and state-ments, if any) is a true, correct, and complete statement of all the information respecting the income tax liability of the corporation for which this report has been prepared of which I/we have any knowledge.</p> | | |
| <p>(Signature of officer if any)</p> <p>Notary Public</p> | | <p>(Signature of person preparing report)</p> |
| <p>(For Department Use)</p> | | <p>TAXING OFFICER</p> <p>DATE</p> |

4 (continued). State Corporation Income Tax Return

Page 2

EXHIBIT I—NET INCOME COMPUTATION—(Must Be Exactly As Reported To Federal Government)

| Item | GROSS INCOME | | |
|--|--------------|--------------|---------------|
| 1 Gross Sales (where inventories are an income-determining factor) | \$ 1,388,900 | | |
| Less Returns and Allowances | 20,000 | | |
| 2 Less cost of goods sold (from Schedule A) | | 1,378,900.00 | |
| 3 Gross profit from sales (Item 1 minus Item 2) | | 794,320.00 | |
| 4 Gross receipts (where inventories are not an income-determining factor) | \$ None | | |
| 5 Less cost of operations (from Schedule B) | None | | |
| 6 Gross profit (where inventories are not an income-determining factor) (Item 4 minus 5) | | | |
| 7 Interest on loans, notes, mortgages, bonds, bank deposits, etc. | | 4,020.00 | |
| 8 Interest on obligations of the United States | | | |
| 9 Rents | | 5,000.00 | |
| 10 Royalties | | | |
| 11 (a) Net short term capital gain (from Schedule C) | | 500.00 | |
| (b) Net long term capital gain (or loss) (from Schedule C) | | | |
| (c) Net gain (or loss) from sale or exchange of property other than capital assets (Submit Schedule) | | | |
| 12 Dividends (from Schedule D) | | 800.00 | |
| 13 Other income (state nature of income) | | 12,180.00 | |
| 14 Total income in items 3, and 12 to 13, inclusive | | | \$ 605,080.00 |
| DEDUCTIONS | | | |
| 15 Compensation of officers | | 40,000.00 | |
| 16 Salaries and wages (not deducted elsewhere) | | 271,335.00 | |
| 17 Rent | | 9,500.00 | |
| 18 Repairs (from Schedule E) | | 14,000.00 | |
| 19 Bad debts (from Schedule F) | | 5,000.00 | |
| 20 Interest (from Schedule G) | | 41,665.00 | |
| 21 Taxes (from Schedule H) (Do not include Federal excess-profits tax)** | | 18,779.16 | |
| 22 Contributions or gifts | | | |
| 23 Losses by fire, storm, etc. (Submit Schedule) | | 11,991.04 | |
| 24 Depreciation (from Schedule I) | | 30,670.00 | |
| 25 Depletion of mines, oil and gas wells, timber, etc. (Submit Schedule) | | | |
| 26 Net operating loss deduction (Submit Statement) | | | |
| 27 Amortization (Submit Schedule) | | | |
| 28 Other deductions authorized by law (Submit Schedule) | | 73,420.00 | |
| 29 Total deductions in items 15 to 28, inclusive | | | 516,160.20 |
| 30 Net income for excess profits tax computation (Item 14 minus Item 29) | | | \$ 88,919.80 |
| 31 Less Federal excess profits tax | | | |
| 32 Net income (Item 30 minus Item 31) | | | |
| 33 Less Interest on obligations of the United States (Item 8, above) | | | |
| 34 Adjusted net income (Item 32 minus Item 33) | | | |

EXHIBIT II—RECONCILIATION OF NET INCOME AND ANALYSIS OF CHANGES IN SURPLUS

| | | | |
|--|---------------|---|---------------|
| 1 Adjusted net income (Item 34, Exhibit I) | \$ 88,919.80 | 13 Unallowable deductions | |
| 2 Non taxable income | | (a) Contributions or gifts, (excess over five per cent limitation) | |
| (a) Interest on United States Savings Bonds and Treasury Bonds owned in the principal amount of \$5000 or less | | (b) Income taxes paid to the United States or its possessions | 16,703.79 |
| (b) Interest on all other Federal, State, and Municipal Securities | 400.00 | (c) Income taxes paid to Foreign Countries | |
| (c) Proceeds of life insurance policies paid upon the death of the insured | | (d) Federal taxes paid on tax free covenant bonds | |
| (d) Other items of non taxable income* | | (e) Special improvement taxes | |
| 3 Charges against reserves for bad debts* | 6,710.00 | (f) Replacements, renewals, and capital expenditures charged to expenses on the books | |
| 4 Charges against reserves for contingencies, etc.* | | (g) Insurance premiums paid on the life of any officer or employee | |
| 5 Total of items 1 to 4, inclusive | \$ 96,029.80 | (h) Unallowable interest incurred in purchasing or carrying exempt interest obligations | |
| 6 Total from item 14 | 21,703.79 | (i) Additions to reserve for bad debts* | 5,000.00 |
| 7 Net profit for year, as shown by books before any adjustments are made therein | \$ 74,326.01 | (j) Additions to reserves for contingencies, etc.* | |
| 8 Surplus and undivided profits as shown by balance sheet at close of preceding taxable year | 158,200.00 | (k) Other unallowable deductions* | |
| 9 Other credits to surplus* | | 14 Total of items 13, 14, and 15 | \$ 21,703.79 |
| 10 Total of items 7 to 9, inclusive | \$ 232,526.01 | 15 Dividends paid during the taxable year | |
| 11 Total from item 17 | 100,000.00 | (a) Amount paid in cash | 50,000.00 |
| 12 Surplus and undivided profits as shown by balance sheet at close of taxable year | \$ 132,526.01 | (b) Amount paid in stock | 50,000.00 |
| | | 16 Other debits to surplus* | |
| | | 17 Total of items 15 and 16 | \$ 100,000.00 |

* Attach Schedule explaining item(s) in detail

** State amount of Pennsylvania and Unemployment Compensation Tax included in this item \$ —

4 (continued). State Corporation Income Tax Return

Page 3

ATTACH ALL RIDERS AND SCHEDULES HERE

EXHIBIT III —BALANCE SHEETS

| ASSETS | Beginning of Taxable Period | | End of Taxable Period | |
|---|-----------------------------|-----------------|-----------------------|-----------------|
| | Amount | Total | Amount | Total |
| 1 Cash | | \$ 42,420.00 | | \$ 55,794.30 |
| 2 Notes receivable | \$ 11,535.00 | | \$ 95,000.00 | |
| 3 Accounts receivable | 210,000.00 | | 300,000.00 | |
| | 221,535.00 | | 395,000.00 | |
| 4 Inventories | | | | |
| (a) Raw materials | \$ 10,320.00 | | \$ 15,000.00 | |
| (b) Work in process | 35,000.00 | | 30,000.00 | |
| (c) Finished goods | 270,000.00 | | 325,000.00 | |
| (d) Supplies | 25,000.00 | | 20,000.00 | |
| | 340,320.00 | | 290,000.00 | |
| 5 Investments (Government obligations) | | | | |
| (a) Obligations of a State, Territory or political subdivision thereof, or the District of Columbia, or United States possessions | \$ 10,000.00 | | \$ 10,000.00 | |
| (b) Obligations of the United States | | | | |
| (c) Obligations of instrumentalities of the United States | | 10,000.00 | | 10,000.00 |
| 6 Other investments | | | | |
| (a) Stocks of domestic corporations | \$ 25,000.00 | | \$ 25,000.00 | |
| (b) Bonds of domestic corporations | 25,000.00 | | 25,000.00 | |
| (c) Stocks and bonds of foreign corporations | | | | |
| (d) Treasury stock | | | | |
| (e) All other investments or loans | | 50,000.00 | | 50,000.00 |
| 7 Deferred charges | | | | |
| (a) Prepaid insurance, taxes, etc. | | 30,000.00 | | 25,000.00 |
| 8 Capital assets | | | | |
| (a) Buildings | \$ 306,000.00 | | \$ 306,000.00 | |
| (b) Machinery and equipment | 207,675.00 | | 207,675.00 | |
| (c) Furniture and fixtures | 21,600.00 | | 21,600.00 | |
| (d) Delivery equipment | 925.00 | | 925.00 | |
| (e) Other depreciable assets | | | | |
| (f) Total of lines (a) to (e) | \$ 536,200.00 | | \$ 536,200.00 | |
| (g) Less reserve for depreciation | 35,515.00 | 500,685.00 | 66,185.00 | 470,015.00 |
| (h) Depletable assets | | | | |
| (i) Less reserve for depletion | | | | |
| (j) Land | | 280,000.00 | | 280,000.00 |
| 9 Other assets (itemize below) | \$ 50,000.00 | | \$ 50,000.00 | |
| | 2,000.00 | | 24,200.00 | |
| | | 52,800.00 | | 74,200.00 |
| 10 Total Assets | | \$ 1,520,050.00 | | \$ 1,644,009.30 |
| LIABILITIES AND CAPITAL | | | | |
| 11 Accounts payable | | \$ 193,000.00 | | \$ 243,200.00 |
| 12 Bonds, notes, and mortgages payable (with original maturity of less than 1 year) | | 90,000.00 | | 113,500.00 |
| 13 Bonds, notes, and mortgages payable (with original maturity of 1 year or more) | | 650,000.00 | | 650,000.00 |
| 14 Accrued expenses | | | | |
| (a) Interest | \$ 7,500.00 | | \$ 8,000.00 | |
| (b) Taxes | 21,350.00 | | 42,583.73 | |
| (c) All others | | 23,850.00 | | 53,683.73 |
| 15 Other liabilities (itemize below) | \$ 40,000.00 | | \$ 91,000.00 | |
| | 40,000.00 | | 91,000.00 | |
| 16 Surplus reserves (include in capital) | | | | |
| | | | | |
| 17 Capital stocks | | | | |
| (a) Preferred stock | \$ 110,000.00 | | \$ 110,000.00 | |
| (b) Common stock | 250,000.00 | 360,000.00 | 250,000.00 | 350,000.00 |
| 18 Premium on capital surplus | | | | |
| 19 Retained surplus and undivided profits | \$ 155,200.00 | 155,200.00 | \$ 132,525.01 | 132,525.01 |
| 20 Total Liabilities and Capital | | \$ 1,520,050.00 | | \$ 1,644,009.30 |

4 (continued). State Corporation Income Tax Return

Page 4

TABLES SUPPORTING DETERMINATION OF ALLOCATING PERCENTAGE

TABLE 1—TANGIBLE PROPERTY (Attach rider, if necessary)

| Description and location of tangible property | Average Book Value | | | Average Actual Value | | |
|---|--------------------|----------------------|------------|----------------------|----------------------|------------|
| | In Pennsylvania | Outside Pennsylvania | Total | In Pennsylvania | Outside Pennsylvania | Total |
| Real Estate <u>Land</u> | \$ 20,000 | \$ 100,000 | \$ 120,000 | \$ 20,000 | \$ 100,000 | \$ 120,000 |
| <u>Buildings</u> | 5,000 | 2,000 | 7,000 | 5,000 | 2,000 | 7,000 |
| (See Rider 5) | | | | | | |
| Equipment and Machinery | 85,000 | 95,000 | 180,000 | 85,000 | 95,000 | 180,000 |
| (See Rider 5) | | | | | | |
| Inventories Mdse. Supplies etc. | 2,000 | 2,000 | 4,000 | 2,000 | 2,000 | 4,000 |
| (See Rider 5) | | | | | | |
| Other Tangible Property | | | | | | |
| None | | | | | | |
| TOTALS | \$ 107,000 | \$ 204,000 | \$ 311,000 | \$ 107,000 | \$ 204,000 | \$ 311,000 |

How were Average Values of Tangible Property determined? Monthly inventories for mdse. etc., yearly inventories for others.

If Actual Values were used explain in detail how determined. Cost less depreciation in case of capital assets.

Inventories at market

State here Total Assessed Value of All Real Estate \$ (See Rider 5)

TABLE 2—WAGES, SALARIES, COMMISSIONS AND OTHER COMPENSATION PAID TO EMPLOYEES (Attach rider, if necessary)

| Location of premises to which wages, salaries, etc. are assignable | Number of employees working in and from this location | Amount assignable to Pennsylvania | Amount assignable outside Pennsylvania | Total wages, salaries, etc. |
|--|---|-----------------------------------|--|-----------------------------|
| 2000 Lake Avenue, Gary, Ind. | 100 | \$ 124,975.00 | \$ 124,975.00 | \$ 124,975.00 |
| 1998 Fourth Avenue, New York, N.Y. | 90 | 258,890.25 | 258,890.25 | 258,890.25 |
| 75 Ellis Ave., Pittsburgh, Pa. | 80 | 111,444.75 | 111,444.75 | 111,444.75 |
| TOTALS | | \$ 495,310.00 | \$ 495,310.00 | \$ 495,310.00 |

TABLE 3—GROSS RECEIPTS (Attach rider, if necessary)

| Locations of places from which gross receipts are assignable to Pennsylvania | Net Sales, Fees, and Commissions | Rentals | Royalties | Interest and Dividends | Other Gross Receipts | Total |
|---|----------------------------------|---------|-----------|------------------------|----------------------|-----------------|
| 75 Ellis Avenue, Pittsburgh, Pa. | \$ 380,572.50 | \$ | \$ | \$ | \$ | \$ 380,572.50 |
| Totals Assignable to Pennsylvania | \$ 380,572.50 | \$ | \$ | \$ | \$ | \$ 380,572.50 |
| Locations of places from which gross receipts are assignable outside Pennsylvania | Net Sales, Fees, and Commissions | Rentals | Royalties | Interest and Dividends | Other Gross Receipts | Total |
| 2000 Lake Avenue, Gary, Ind. | \$ 5,000 | \$ | \$ | \$ | \$ | \$ 5,000 |
| 1998 Fourth Avenue, New York, N.Y. | 1,001,147.50 | \$ | \$ | \$ | \$ | \$ 1,001,147.50 |
| Totals Assignable outside Pennsylvania | \$ 1,006,147.50 | \$ | \$ | \$ | \$ | \$ 1,006,147.50 |
| Grand Total—All Gross Receipts | \$ 1,386,720.00 | \$ | \$ | \$ | \$ | \$ 1,386,720.00 |

GENERAL INFORMATION

- Nature of business Manufacture & Sale
- The Corporation's books are in care of Dexter Blake
Located at 1998 Fourth Avenue, New York, N.Y.
- Is this return made on the basis of actual receipts and disbursements? No If not, describe fully what other basis or method was used in determining net income Accrual Method
- State basis of inventory valuation Cost
- Collection district in which Federal Income tax return was filed Third District of New York
- Has the Federal Government changed the net income as originally reported for 1937? No 1938? No 1939? No
If so, has "Report of Change in Corporate Net Income" (Form No. RCN-1a, which will be furnished upon request) been filed with Department of Revenue as required by law? (Yes or No) No
- (a) Is this a parent, holding, affiliated or subsidiary company? (Yes or No) No
(b) If the answer is "Yes", give the name and address of the parent, holding, affiliated or subsidiary company or companies. (Attach separate list, if necessary) None
(c) Is the parent, holding, affiliated or subsidiary company or companies registered with or incorporated in the Commonwealth of Pennsylvania? None

4 (concluded). State Corporation Income Tax Return

| SCHEDULE A—COST OF GOODS SOLD (Where Inventories Are an Income-determining factor) | | | | SCHEDULE B—COST OF OPERATIONS (Where Inventories Are Not an Income-determining factor) | | | |
|---|--|---------------|--|---|-----------------------------------|--|--|
| 1 | Inventory at beginning of year | \$ 340,320.00 | | 1 | Salaries and Wages | | |
| 2 | Material or Merchandise bought for Manufacture or Sale | 550,000.00 | | 2 | Other Costs (to be Detailed) | | |
| 3 | Salaries and Wages | 183,975.00 | | (a) | | | |
| 4 | Other Costs per books | 10,025.00 | | (b) | | | |
| 5 | Total (Lines 1 to 4) | 1,074,320.00 | | (c) | | | |
| 6 | Less Inventory at End of Year | | | (d) | | | |
| 7 | Cost of goods (Enter as Item 3 Exhibit I) | \$ 794,320.00 | | (e) | | | |
| | | | | 3 | Total (Enter as Item 5 Exhibit I) | | |

| SCHEDULE C—GAINS AND LOSSES FROM SALES OR EXCHANGES REPORTED IN ITEMS 11(a) AND 11(b), EXHIBIT I | | | | | | | |
|--|------------------|-------------------------------------|------------------------|--|--|---|--|
| 1. Description of Property | 2. Date Acquired | 3. Gross Sales Price (Gross Profit) | 4. Cost or Other Basis | 5. Expense of Sale and Cost of Improvements Subsequent to Acquisition or March 1, 1913 (Furnish details) | 6. Depreciation allowed (or Allowable) (See Regulations or Circulars (Form 114)) | 7. Short-Term Gain or Loss on Capital Assets (Form 114) | 8. Long-Term Gain or Loss on Capital Assets (Form 114) |
| Tangible capital assets | | | | | | | |
| Land (unimproved) | 2/1/40 | \$2,000 | \$1,500 | | | \$500 | |
| Outside Penna | | | | | | | |
| Securities and other intangibles | | | | | | | |
| GAIN (OR LOSS) (enter net amounts as item 11(a) 12 (b) 11(b) in Exhibit I) | | | | | | \$ 500 | \$ |

State (1) how property was acquired — By purchase, (2) Whether at time of sale or exchange purchaser owned more than 50% in value of your outstanding stock No.

Every sale or exchange of stock should be reported in detail including name and address of corporation, class of stock, number of shares, capital changes affecting basis (stock dividends other non taxable dividends stock rights etc.)

| SCHEDULE D—DIVIDENDS (Page 1, Computation of Tax, Item 3) | | |
|---|------------------------------|-----------------|
| Received from (Give exact corporate title) | Address | Amount Received |
| Acme Tool Company, Inc. | 750 Mill St., Buffalo, N. Y. | \$ 800.00 |
| TOTAL | | \$ |

| SCHEDULE E—COST OF REPAIRS | | | SCHEDULE F—BAD DEBTS | | |
|----------------------------|---|---|----------------------|---------------------|---|
| 1. Item | 2. Amount (Enter as Item 16, Exhibit I) | 3. Amount (Enter as Item 20, Exhibit I) | 1. Taxable Year | 2. Refers to Amount | 3. Bad Debts Charged (If by Corporation or If the Referee is Corporation or Bank) |
| Salaries and wages | | | 1936 | | |
| Other costs | 14,000.00 | | 1937 | | |
| | | | 1938 | 46,250 | 12,000 |
| | | | 1939 | 320,820 | 470 |
| | | | 1940 | 1,305,100 | 5,000 |
| TOTAL | \$ 14,000.00 | | | | 6,710 |

| SCHEDULE G—INTEREST | | | SCHEDULE H—TAXES | | |
|---------------------|-------------------------|---|------------------|-----------------|---|
| 1. On What Paid | 2. Amount Actually Paid | 3. Amount (Enter as Item 20, Exhibit I) | 1. Nature of Tax | 2. To Whom Paid | 3. Amount (Enter as Item 21, Exhibit I) |
| Bonds | \$ 35,000 | \$35,000 | Fed. Cap. Stk. | D. S. | \$ 600.00 |
| Notes | 6,665 | 6,665 | Pa. Franchise | Pa. | 4,392.15 |
| | | | Pa. Franchise | Pa. | 1,159.30 |
| | | | N. Y. Franchise | N. Y. | 1,522.00 |
| | | | | | 6,710 |
| TOTALS | \$ 41,665 | \$41,665 | TOTAL | | \$18,579.15 |

| SCHEDULE I—EXPLANATION OF DEDUCTION FOR DEPRECIATION (Attach rider, if necessary) | | | | | | | |
|---|------------------|------------------------|---|---|--|--|-------------------------------------|
| 1. Kind of Property (If Buildings, State Material or Work Constructed) | 2. Date Acquired | 3. Cost or Other Basis | 4. Assets Fully Depreciated in Use at End of Year | 5. Depreciation Allowed (or Allowable) in Prior Years | 6. Remaining Cost or Other Basis to Be Recovered | 7. Estimated Life Used in Accounting (See Regulations) | 8. Depreciation Allowable This Year |
| Buildings | 2/2/29 | \$205,000 | | \$19,550 | \$185,450 | 30 yrs | 10,200 |
| Machinery & Equip | 2/2/29 | 20,000 | | | 20,000 | 15 yrs | 3,245 |
| Furn & Fix | 2/2/29 | 21,000 | | | 21,000 | 15 yrs | 4,400 |
| Others (See Rider 7) | | | | | | | 5,115 |
| TOTAL (Enter as item 24 Exhibit I) | | | | | | | \$18,579.15 |

| SCHEDULE J—DETAILED STATEMENT OF FEDERAL TAXES AS REPORTED IN COMPUTATION OF TAX | | |
|--|----------------------------|---------------------------|
| 1. Kind | 2. Year in Which Available | 3. Amount Paid or Accrued |
| Normal Income Tax | 1940 | \$ 11,821.83 |
| Surplus—capital stock from federal return | 1940 | 3,187.57 |
| Defense Tax | 1940 | 1,694.39 |
| TOTAL (Enter as Item 2, Computation of Tax, Page 1) | | \$ 16,703.79 |

5. State Capital Stock Tax Return

STATE AUDITOR'S FORM—OCT. 30, 1940
DO NOT USE THIS SPACE

DOMESTIC
FRANCHISE TAX RETURN

File with Secretary of State, Austin, Texas, on or before March 15, 1941, to avoid 10% Statutory penalty

Please Insert Your Account Number Here

Pre. Audit by _____
Date Posted _____
Filed by _____
Final Audit by _____

(1) Name X. Y. Z Corporation Principal Place of Business Galveston, Texas
(2) Mailing Address 123 Main Street, Galveston Principal Place of Business in Texas _____
Street and Number
Galveston Texas State of Your Business Chemical products
City County State

(3) Gross Receipts for the Accounting Year ended 1940
Must be Prior to January 1, 1941.

| | AMOUNT | PERCENTAGES |
|---|-----------------|-------------|
| (a) Business done in Texas | \$ 978 900 00 | 71 00 % |
| (b) Business done outside of Texas | \$ 400 000 00 | 29 00 % |
| (c) TOTAL GROSS RECEIPTS (Item 4 of schedule "B") | \$ 1 378 900 00 | 100 00 % |

Do you keep a book record showing separately the amount of business done in Texas and the amount of business done outside of Texas? Yes
If not, how was the above information determined? _____

Taxable Capital at December 31 1940
Close of last accounting year prior to January 1, 1941.

| (6) Capital Stock | AUTHORIZED | | AMOUNT ACTUALLY PAID IN | SUBSCRIBED AND OUTSTANDING (Including Treasury Stock) |
|-------------------------|------------|-----------|-------------------------|---|
| | Shares | Par Value | | |
| (a) Preferred | 150,000 | \$ 50 | \$ 130 000 00 | |
| (b) Common | 300,000 | 100 | 270 000 00 | |
| (c) TOTAL CAPITAL STOCK | | | \$ 400 000 00 | |

(7) Surplus and Undivided Profits (Item 16, a to f inclusive, schedule "A") 1015 000 00
(8) Total Capital and Surplus (Total of 6 and 7—Taxable Capital for Group C Corporations) 1 015 000 00
(9) Bonds, Notes, and Debentures maturing one year or more from date of issue 50 000 00
(10) Total Taxable Capital (Items 8 and 9 above—should be same as Item 17 of schedule "A") 1 065 000 00

"CAPITAL STOCK" as applied to corporations without capital stock shall mean the net assets. In case of no par value stock, write the word "NO" in the space provided for par values. Report the value actually received at date of issue.

COMPUTATION OF TAX
FRACTIONAL PART OF \$1,000 IS TAXABLE AS FULL \$1,000

| (11) Group A—(All Corporations except Public Utilities) | AMOUNT TAXABLE | | | | AMOUNT OF TAX | | | |
|--|-----------------|-----|-----|----|---------------|-----|-----|----|
| | \$ | 100 | 150 | 00 | xxx | xxx | xxx | xx |
| BASIS OF TAX—Item 10 multiplied by percentage opposite 5 (a) (a) Tax at 60c per \$1,000 on not to exceed \$1,000,000 (Minimum tax \$10 00) (b) Tax at 30c per \$1,000 on amount in excess of \$1,000,000 | \$ 1 182 150 00 | | | | xxx | xxx | xxx | xx |

(12) Group B—(Street and Interurban Railways and all Corporations Required to pay the Intangible Tax)
1/8 of the tax computed under group A (Minimum tax \$10 00)

| | xxx | xxx | xxx | xx |
|--|-----|-----|-----|----|
| | | | | |

(13) Group C—(All other Public Utilities, engaged solely in the business of a Public Utility whose Rates or services are regulated or subject to regulation, in whole or in part, by law)
BASIS OF TAX—Item 8 multiplied by percentage opposite 5 a
(a) Tax at 65c per \$1,000 on not to exceed \$1,000,000 (Minimum tax \$10 00)
(b) Tax at 45c per \$1,000 on not to exceed \$9,000,000
(c) Tax at 35c per \$1,000 on amount taxable in excess of \$10,000,000

| | \$ | xxx | xxx | xxx | xx |
|--|----|-----|-----|-----|----|
| | | | | | |

(14) Group D—(Multiple Purpose Corporations and Corporations whose operations fall partially under Group A and partially under Group C)
 (a) Tax computed under GROUP A
 (b) Tax computed under GROUP C
 (c) TOTAL (Combined if under both groups A and C)
 (d) ADD 1/2 of (A) (B) or (C) for each additional purpose

| | AMOUNT OF TAX |
|--|---------------|
| | \$ |
| | |
| | |
| | |

(15) TOTAL TAX PAYABLE (Minimum total \$10 00) \$ 654 90
(16) 10% Penalty for late report
(17) 25% Penalty for late payment
(18) REVIVAL LIFE 5% per
(19) TOTAL AMOUNT DUE \$ 654 90

If the event Schedules contained herein do not provide sufficient space for the information required, Supplemental Schedules should be prepared and submitted WITH THIS RETURN.

NUMBER all Reports, Supplemental Schedules and Correspondence the same as number shown above after name of company

PAYMENT OF TAX. The tax should be paid by sending or bringing with the attached remittance slip a certified or cashier's check, money order or bank draft drawn to the order of the "Secretary of State, Austin, Texas" on or before May 1, 1941

5 (continued). State Capital Stock Tax Return

SCHEDULE A—BALANCE SHEETS

Prior to January 1, 1943

| ITEMS | BEGINNING OF ACCOUNTING YEAR 19 | | END OF ACCOUNTING YEAR 19 | |
|---|---|--|---|--|
| | I—AMOUNT | II—TOTALS | III—AMOUNT | IV—TOTALS |
| ASSETS | | | | |
| 1 Cash | | \$ 51 530 00 | | \$ 75 000 00 |
| 2 Notes and Accounts Receivable. Less Reserve for bad debts. | \$ 305 000 00 | 305 000 00 | \$ 425 000 00 | 425 000 00 |
| 3 Inventories (a) Raw materials (b) Work in progress (c) Finished goods (d) Supplies | | 340 320 00 | | 290 000 00 |
| 4 Investments (a) U S Gov't Obligations. (b) Stock in Texas Corporations (c) Other investments | \$ 30 000 00 40 000 00 10 000 00 | 80 000 00 | \$ 30 000 00 40 000 00 30 000 00 | 100 000 00 |
| 5 Capital Assets (a) Depreciable Assets (Itemize) Buildings Machinery Furniture Fixtures Total Depreciable Assets Less—Depreciation Reserves. (b) Depletable Assets Less—Depletion Reserves Excess of Depletion Reserve over Leasehold Costs (Tax- able Item 16-f) (c) Land | \$ 350 000 00 251 500 00 18 500 00 630 000 00 \$ \$ 280 000 00 | 630 000 00 280 000 00 | \$ 350 000 00 251 500 00 18 500 00 630 000 00 \$ \$ 280 000 00 | 630 000 00 280 000 00 |
| 6 Other Assets (Itemize) Deferred charges Patents | \$ 38 000 00 400 000 00 | 438 000 00 | \$ 50 000 00 400 000 00 | 450 000 00 |
| 7 Capital Stock Subscriptions | | | | |
| 8 Treasury or Rescued Stock | | | | |
| TOTAL ASSETS | | \$ 2 124 670 00 | | \$ 2 250 000 00 |
| LIABILITIES | | | | |
| 9 Accounts Payable | | \$ 389 000 00 | | \$ 389 000 00 |
| 10 Bonds, Notes and Debentures maturing less than one year | | | | |
| 11 A | | 14 000 00 | | 14 000 00 |
| 12 Other Liabilities (Itemize) | | 141 000 00 | | 172 000 00 |
| TAXABLE CAPITAL | | | | |
| 13 Bonds, Notes and Debentures maturing one year or more | | | | |
| 14 P | | | | |
| 15 C | | | | |
| 16 Surplus (a) Earned (b) Capital or Paid In Surplus (c) Appropriated Surplus (d) Surplus from Appreciation (e) Surplus Reserves (Contingencies, etc) (f) Excess of Depletion Reserve over Leasehold Costs (Item 16-b above) | 495 670 00 75 000 00 | | 540 000 00 75 000 00 | |
| 17 Total Taxable Capital (Items 13 to 16) | \$ 1 560 670 00 | 1 560 670 00 | \$ 1 665 000 00 | 1 665 000 00 |
| 18 If a Deficit (if any) | | | | |
| TOTAL LIABILITIES | | \$ 2 124 670 00 | | \$ 2 250 000 00 |

Are STIPULATED that
If NOT so stated

IN ORDER TO AVOID PENALTY FOR FAILURE TO FILE SCHEDULES AND ANSWER ALL QUESTIONS FULLY

Return for tax on capital stock for the year ending December 31, 1942, is filed with this return. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission.

Return for tax on capital stock for the year ending December 31, 1942, is filed with this return. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission. The return is based on the information furnished by the corporation and is subject to audit by the State Tax Commission.

5 (continued). State Capital Stock Tax Return

SCHEDULE B—ANALYSIS OF CHANGES IN TAXABLE CAPITAL

For the Accounting Year Begun January 1st 19 40 and Ended December 31st 19 40
Must be Prior to January 1, 1941

| | | | | | | | |
|-------------------------------|---|------------------------|-------------------------------|-----------------------|--------|-----|------------|
| 1 | Gross Sales, less returns and allowances (trading or manufacturing) | | \$ | 1 | 378 | 900 | 00 |
| 2 | Gross Receipts from Operations (other than trading or manufacturing) | | | | | | |
| 3 | Other Income | | | | | | |
| (a) | Interest on loans, notes, mortgages, bonds, bank deposits, etc. | \$ | | | | | |
| (b) | Interest on obligations of the United States | | 2 | 200 | 00 | | |
| (c) | Rents | | 3 | 000 | 00 | | |
| (d) | Royalties received (furnish schedule of sources) | | 2 | 000 | 00 | | |
| (e) | Dividends Received Texas | | 800 | 00 | | | |
| (f) | Other Income (State nature of income) Discounts | | 10 | 580 | 00 | | |
| (g) | Sale of Stock \$500 and Interest \$2,020 | | 2 | 520 | 00 | | |
| (h) | | | | | | 21 | 100 00 |
| 4 | Total Gross Receipts (Items 1 to 3f inclusive) | \$ | 979 | 320 | 00 | | |
| 5 | Cost of Goods Sold (from schedule C—trading or manufacturing) | \$ | | | | | |
| 6 | Cost of Operations (from schedule D—other than trading or mfg.) | | 25 | 000 | 00 | | |
| 7 | Compensation of Officers | | 140 | 500 | 00 | | |
| 8 | Salaries and Wages (not included elsewhere) | | | | | | |
| 9 | Rent | | 14 | 000 | 00 | | |
| 10 | Repairs | | 16 | 340 | 00 | | |
| 11 | Bad Debts Loss | | 39 | 990 | 00 | | |
| 12 | Interest | | 15 | 000 | 00 | | |
| 13 | Taxes (from schedule F) | | | | | | |
| 14 | Contributions or Gifts Paid | | | | | | |
| 15 | Losses by Fire, Storm, Shipwreck, or other Casualty, or Theft | | | | | | |
| 16 | Depreciation Buildings | | 25 | 000 | 00 | | |
| 17 | Depletion of Mines, Oil & Gas Wells, Timber, etc., (submit schedule) | | | | | | |
| 18 | Other Expenses (Itemize) | | 63 | 760 | 00 | | |
| | | | | | | 1 | 320 000 00 |
| 19 | NET PROFIT (total of Items 5 to 18 inclusive, deducted from Item 4) | (SHOW LOSS IN RED) | \$ | | | 80 | 000 00 |
| 20 | DIRECT CREDITS TO SURPLUS (Itemize) | \$ | | | | | |
| (a) | | | | | | | |
| (b) | | | | | | | |
| (c) | | | | | | | |
| 21 | Total of Items 19 and 20 | \$ | | | | | |
| 22 | DIRECT CHARGES TO SURPLUS (Itemize) | \$ | | | | | |
| (a) | Federal Income Taxes | \$ | 8 | 470 | 00 | | |
| (b) | Cash Dividends (Last payment date, Amt \$) | | 27 | 200 | 00 | | |
| (c) | Stock Dividends | | | | | | |
| (d) | | | | | | | |
| (e) | | | | | | 35 | 670 00 |
| 23 | Net Change in Surplus (Item 21 less Item 22) | (SHOW DECREASE IN RED) | \$ | | | 44 | 330 00 |
| 24 | Net Capital at Beginning of Year (Item 18, column II of Schedule "A") | | | | | 1 | 580 670 00 |
| 25 | ADDITIONS TO CAPITAL | | | | | | |
| (a) | Bonds, notes and debentures—maturing one year or more from date of issue, added during period | \$ | | | | | |
| (b) | Capital Stock Subscribed Preferred \$20,000 Common \$20,000 | | 40 | 000 | 00 | | |
| (c) | Stock Dividends | | | | | 40 | 000 00 |
| 26 | Total of Items 23 to 25 inclusive | \$ | | | | 1 | 665 000 00 |
| 27 | DEDUCTIONS | | | | | | |
| (a) | Bonds, notes and debentures—maturing one year or more from date of issue, retired during period | \$ | | | | | |
| (b) | Capital stock retired by charter amendment | | | | | | |
| (c) | Preferred stock retired by cancellation | | | | | | |
| 28 | Net Capital at End of Year (Item 18, column IV of Schedule "A") | \$ | | | | 1 | 665 000 00 |
| 29 | Add Deficit (if any) at End of Year (Item 18, column III of Schedule "A") | | | | | | |
| 30 | Taxable Capital at End of Year (item 17, column III of Schedule "A") | \$ | | | | 1 | 665 000 00 |
| Schedule C—Cost of Goods Sold | | AMOUNT | Schedule D—Cost of Operations | | AMOUNT | | |
| 1 | Inventory at Beginning of period | \$ 340 320 00 | 1 | Salaries and Wages | \$ | | |
| 2 | Material or Merchandise bought for manufacture or sale | 400 000 00 | 2 | Other Costs (Itemize) | | | |
| 3 | Salaries and Wages | 180 000 00 | (a) | | | | |
| 4 | Other Costs per books | 349 000 00 | (b) | | | | |
| 5 | Total of lines 1 to 4 inclusive | \$ 1 209 320 00 | (c) | | | | |
| 6 | Inventory at end of period (deduct) | 230 000 00 | (d) | | | | |
| 7 | Cost of Goods Sold (Item 5 of Schedule B) | \$ 979 320 00 | (e) | | | | |
| | | | TOTAL (Item 6 of Schedule B) | | \$ | | |

REMARKS:

5 (concluded). State Capital Stock Tax Return

SCHEDULE E—ALL BONDS, NOTES AND DEBENTURES OWED

| (1) Dates of Issue or Last Renewal | | | (2) PAYER-NAME AND ADDRESS | (3) DUE DATES* | | | (4) | (5) |
|---|-----|------|--|-------------------|-----|------|--|--|
| Mo. | Day | Year | | Mo. | Day | Year | Amount maturing less than one year from Date of issue | Amount maturing one year or more from Date of issue |
| 1 | 1 | 30 | Several hundred payees of this bearer bond | 1 | 1 | 45 | \$ | \$ 400 000 00 |
| 1 | 1 | 30 | Several hundred payees of this bearer bond | 1 | 1 | 50 | | 250 000 00 |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| | | | | | | | | |
| Totals of columns 4 and 5, Schedule A, should agree with lines 10 and 13. | | | | | | | \$ | \$ 650 000 00 |

Totals of columns 4 and 5, Schedule A, should agree with lines 10 and 13. \$ \$ 650 000 0

NOTE* In case of installment notes, show amount and due dates of installments. Report installments maturing less than one year from date of issue in column (4) subsequent installments in column (5), if space is insufficient, attach supplemental schedule.

SCHEDULE F—TAXES[illegible]

NOTE If Space Is Insufficient, Attach Supplemental Schedule

OFFICERS AND DIRECTORS (Print All Names)
(All Corporations Must Have at Least Three Directors)

| | Name | Address | Title |
|----|-------------|-----------------------------------|-----------------------|
| 1. | John Smith | 111 Bold Street, Galveston, Texas | President & Director |
| 2. | John Doe | 111 Bold Street, Galveston, Texas | Vice-Pres. & Director |
| 3. | Richard Roe | 111 Bold Street, Galveston, Texas | Secretary |
| 4. | Henry Brown | 111 Bold Street, Galveston, Texas | Treasurer |
| 5. | A. C. Lee | 58 High Street, Galveston, Texas | Director |
| 6. | R. C. Davis | 62 High Street, Galveston, Texas | Director |
| 7. | F. C. Lane | 15 Franklin St., Galveston, Texas | Director |

Process in any suit against the corporation may be served upon Richard Roa
residing in Texas at 111 Bold Street, Galveston, Texas
Street Number and City

I, Henry Brown being Treasurer of the
Prov. V. P. Sec. Treas. of Gen. Hqs.

above named corporation whose return for State franchise tax is herein set forth do solemnly swear that the items entered in the foregoing report and in any additional list or lists attached to or accompanying this list are true, to my best knowledge and belief, true and correct.

Subscribed and sworn to before me this 28th day of February 1941

(See D)

Notary Public in and for Galveston, Texas

Report Cannot Be Accepted Unless Signed Before Notary

[illegible]

Appendix F—Commodity Tax Administration

1. State Sales Tax Return

State Tax Commission
Form 3-A

ARIZONA TAX COMMISSION
PRIVILEGE SALES TAX DIVISION
REPORT OF GROSS INCOME—MONTHLY

For the Period Beginning _____, 193____, Ending _____, 193____

FIRM NAME _____
As Shown On License

ADDRESS _____
Street No. or P. O. Box _____ City _____ License Number _____

NATURE OF BUSINESS _____

DO NOT USE THIS SPACE—FOR CASHIER ONLY

NOTE
Firm Name Must Be Same
As It Appears On License

Code
No. _____

County _____

Industry
Code _____

This statement must be filed with the Tax Commission on or before the 15th day of each month next succeeding the period for which filed.

COMPUTATION OF TAX—BUSINESS CONDUCTED IN ARIZONA

| COLUMN 1 Taxable Activities and Business Classifications | Code | Class | COLUMN 2 Gross Amt. | COLUMN 3 Deductions | COLUMN 4 Taxable Amount | Col 5 Rate | COLUMN 6 Amount of Tax | Do Not Use |
|---|------|-------|------------------------|------------------------|-------------------------------|---------------|---------------------------|------------------|
| Manufacturing: Selling, crating, boxing, barrel ling, canning, bottling, soaking, preserving, processing, or otherwise preparing for sale agricultural, horticultural products. | A-1 | | | | | 1% | | |
| Transporting: For hire persons or property by motor vehicle from one point to another point in this state. | B-1 | | | | | 1% | | |
| Mining: Quarrying, smelting, producing for sale any oil, natural gas, limestone, sand, gravel, copper, gold, silver or other mineral products, selling, producing, preparing timber products. | C-1 | | | | | 1% | | |
| Utilities: Furnishing to consumers electricity, elec- tric lights, current, power or gas, natural or artificial, and water. | C-2 | | | | | 1% | | |
| Communications: Transmitting long distance messages or conversations by telephone, or messages by telegram from one point to another point in the state including tele. subscriptions, publications. | C-3 | | | | | 1% | | |
| Rail Roads: Transporting for hire freight or pas- sengers by railroad from one point to another in the state. | C-4 | | | | | 1% | | |
| Pipe Line: Operating a pipe line or lines for trans- porting of oil or natural or artificial gas through pipes or conduits from one point to another in the state. | C-5 | | | | | 1% | | |
| Private Car: Operating private car lines, as such are defined in Section 214 Revised Code of 1923, from one point to an- other point in this state. | C-6 | | | | | 1% | | |
| Publishing: Publication of newspapers, magazines or other periodicals and publications when published within this state, in- cluding subscriptions, advertising, and notices. | C-7 | | | | | 1% | | |
| Job Printing: Engraving, embossing, copying, advertising by bill boards, direct mail, radio or by any means not related to appeal to prospective purchasers. | C-8 | | | | | 1% | | |
| Restaurants: Dining cars, dining rooms, lunch rooms, lunch stands, soda fountains, or similar establishments where or wherein food or drink are sold for consumption on the premises or on such dining cars. | E-1 | | | | | 1% | | |
| Amusements: Operating or conducting theatres, movies, operas, shows of any type or nature, exhibitions con- certs, carnivals, circuses, amusement, parties, masques, cises, fairs, races, contests, games, bullfights and pool parties and bowling alleys, public dances, dance halls, boxing matches, wrestling matches, and any business charging admission fees for exhibition, amusement or instruction. | F-1 | | | | | 2% | | |
| Rentals: Hotels, guest houses, clubs, ranches and resorts, rooming houses, apartment houses, office buildings, automobile rental service, automobile storage garages, parking lots, summer camps or any other business or occupation, charging storage fees or rental and equipment and credit bureaus and collection agencies. | F-2 | | | | | 2% | | |
| Meat Packing: Slaughtering animals for food, packing, processing or com- minuting meat or meat products. (Labor deductible from total gross receipts.) | G | | | | | 1/4 of 1% | | |
| Contracting: | H | | | | | 1% | | |
| Feed-Wholesale: Selling poultry or stock food to poultrymen or producers of poultry and poultry prod- ucts or to stockmen or feeders of stock, at wholesale rates, for their own use and not for resale. | I | | | | | 1/4 of 1% | | |
| Retail: Selling any tangible personal property what- soever at retail, except bonds and stocks. (All retail stores. All sales to consumers.) | D | | | | | 2% | | |
| XXX XX TOTAL TAX DUE XXXX | | | | | | | | |
| PENALTY | | | | | | | | |
| LESS CREDIT VOUCHER | | | | | | | | |
| TOTAL REMITTANCE | | | | | | | | |

DO NOT USE THIS SPACE—FOR CASHIER ONLY

MONEY ORDER
CHECK
CASH

Date _____ Number _____ Amount _____ Bank _____ City _____

AFFIDAVIT

I swear (or affirm) that this return has been examined by me, and to the best of my knowledge and belief, is a true and complete return for the taxable period as stated, pursuant to the Excise Revenue Act of 1935.

Sworn to and subscribed before me this _____ day _____, 193____

Signature of Taxpayer _____

**NOTARIAL
SEAL**

Signature of officer administering oath _____

(Title) _____

(Date) _____

RECEIPT WILL BE GIVEN UPON REQUEST

1 (concluded). State Sales Tax Return

SCHEDULE A

DETAIL OF DEDUCTIONS

Special Instruction: If any deduction has been taken in Column 3 Page 1 complete this schedule.

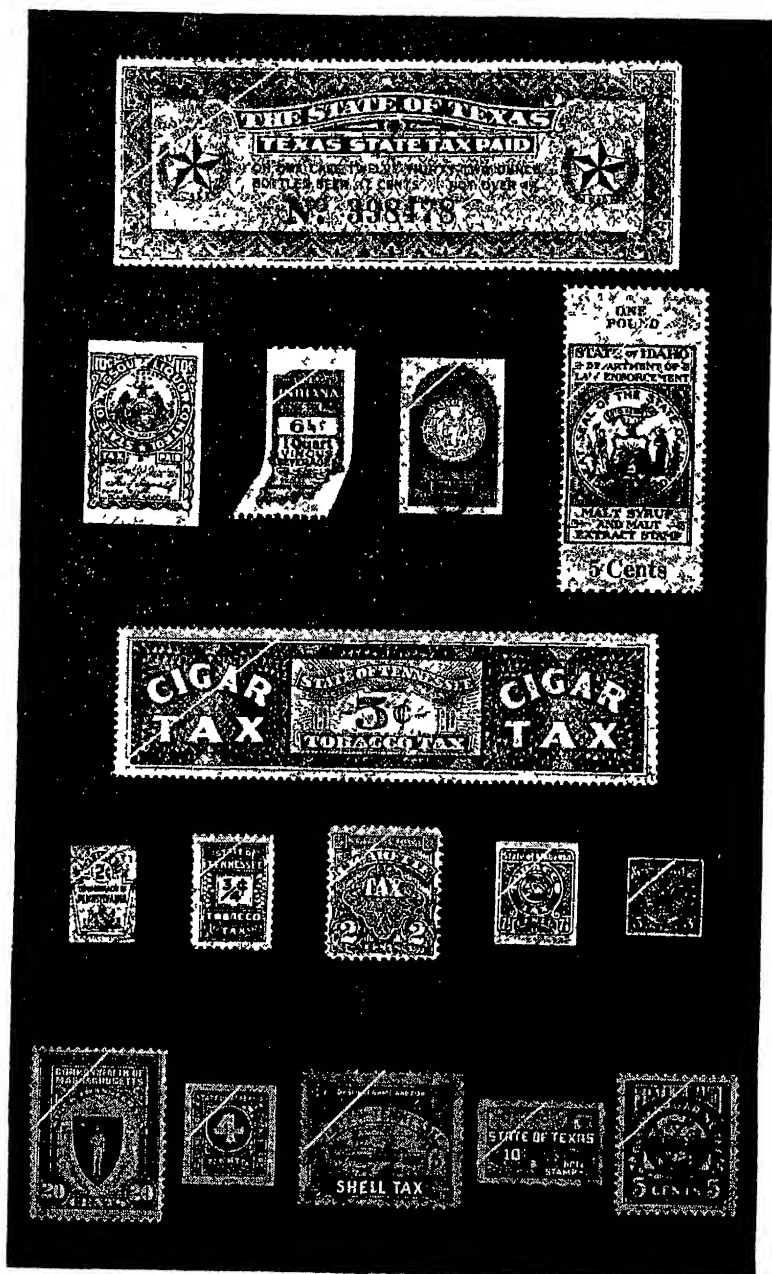
| Type of Deduction | Amount |
|---|--|
| Trade Discounts | Trade discounts allowed and deducted by the seller |
| Freight Out | Allowable to seller only, not to purchaser—Actual freight or delivery charges (1) Paid to the carrier by the seller and invoiced to the purchaser as such, or, (2) paid by the purchaser to the carrier (other than the seller) and deducted from the invoice price by the purchaser. Applies to businesses in subdivision (a) and par 1 of subdivision (c) of Sec. 2. |
| Cash Discount, or Refunds | Cash discounts actually allowed by the taxpayer and taken by the purchaser, if the amount thereof has been included in value of products, gross proceeds of sales or gross income reported for tax purposes. |
| Gasoline | State of Arizona and Federal tax upon gasoline actually sold. |
| Bad Debts | No deduction will be allowed unless list is attached |
| CONTRACTING | Payments made by the contractor for labor |
| Sales to U. S. Gov't | Proceeds of sales to the United States Government, its departments or institutions. |
| TOTAL amount of deductions, as reported in Column 3 Page 1. | |

THIS SCHEDULE TO BE USED WHEN SALES ARE MADE IN MORE THAN ONE COUNTY

RECORD OF SALES MADE IN THE COUNTIES OF THE STATE OF ARIZONA

| DISTRIBUTION TO COUNTIES BY CLASSIFICATION | | | | | |
|--|-----------------------------------|---------------------|-------------------|-------------------------|-------------------|
| Number Stores | Counties in Which Sales Were Made | Total Taxable Sales | Total Tax Payable | Total Taxable Sales | Total Tax Payable |
| | APACHE | | | | |
| | COCHISE | | | | |
| | COCONINO | | | | |
| | GILA | | | | |
| | GRAHAM | | | | |
| | GREENLEE | | | | |
| | MARICOPA | | | | |
| | MOHAVE | | | | |
| | NAVAJO | | | | |
| | PIMA | | | | |
| | PINAL | | | | |
| | SANTA CRUZ | | | | |
| | YAVAPAI | | | | |
| | YUMA | | | | |
| | Gross Total Taxable Sales | | | | |
| | Gross Total Tax Payable | | | Gross Total Tax Payable | |

2. Selected State Revenue Stamps (three-quarters size)



| SAMPLE COPY SCHEDULE A To be made out in duplicate and attached to and made a part of Tax Return | FORM GA 2 STATE OF NEW JERSEY | Month of _____ Year _____ | | | | |
|---|--|---|----------|--------------|----------------|----------------|
| Name _____ Address _____ | | | | | | |
| LINE 2—Form GA 1—Receipts at all marketing locations in N J from sources outside N J | | | | | | |
| | | GALLONS <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 50%;">TAX PAID</th> <th style="width: 50%;">TAX NOT PAID</th> </tr> <tr> <td style="text-align: center;">XXXX XXXX XXXX</td> <td style="text-align: center;">XXXX XXXX XXXX</td> </tr> </table> | TAX PAID | TAX NOT PAID | XXXX XXXX XXXX | XXXX XXXX XXXX |
| TAX PAID | TAX NOT PAID | | | | | |
| XXXX XXXX XXXX | XXXX XXXX XXXX | | | | | |
| (a) Summary Total of Daily Import Reports No. _____ to No. _____ (b) Imports from consignors outside of N J via tank car barge vessel, received tax paid, and via tank wagon received tax paid or tax not paid (c) Imports from _____ storage or refineries located outside of N J (d) Imports from _____ outside N J—List individually (e) Imports in transit via tank car barge or vessel—List individually | Consignor _____ State From _____ Carrier _____ State From _____ | | | | | |

| SAMPLE COPY SCHEDULE B To be made out in duplicate and attached to and made a part of Tax Return | FORM GA-3 STATE OF NEW JERSEY | Month of _____ Year _____ | | | | |
|--|--|---|----------|--------------|----------------|----------------|
| Name _____ Address _____ | | | | | | |
| LINE 3—Form GA-1—Receipts at marketing locations in N J from sources within N J | | | | | | |
| | | GALLONS <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 50%;">TAX PAID</th> <th style="width: 50%;">TAX NOT PAID</th> </tr> <tr> <td style="text-align: center;">XXXX XXXX XXXX</td> <td style="text-align: center;">XXXX XXXX XXXX</td> </tr> </table> | TAX PAID | TAX NOT PAID | XXXX XXXX XXXX | XXXX XXXX XXXX |
| TAX PAID | TAX NOT PAID | | | | | |
| XXXX XXXX XXXX | XXXX XXXX XXXX | | | | | |
| (a) Receipts from own refineries (b) Receipts from blending and compounding at marketing locations (c) Receipts from vendors—by consignee (d) Receipts from returns from customers—list individually (e) Receipts in transit—via tank car barge vessel—list individually | Consignor _____ State From _____ Carrier _____ State From _____ | | | | | |

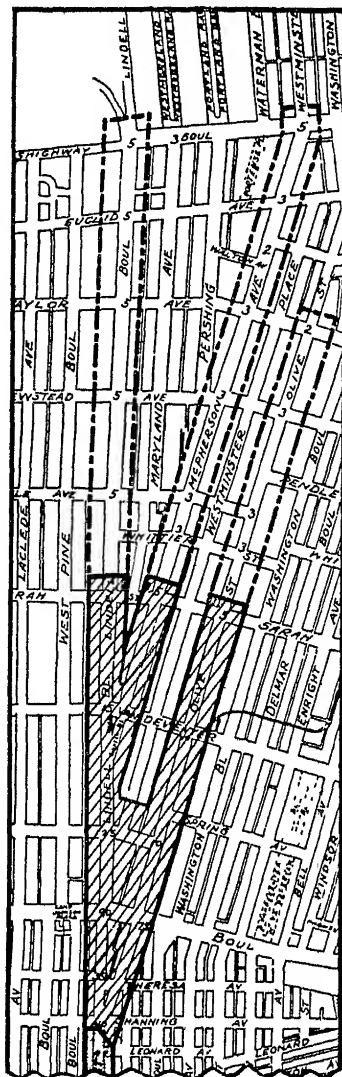
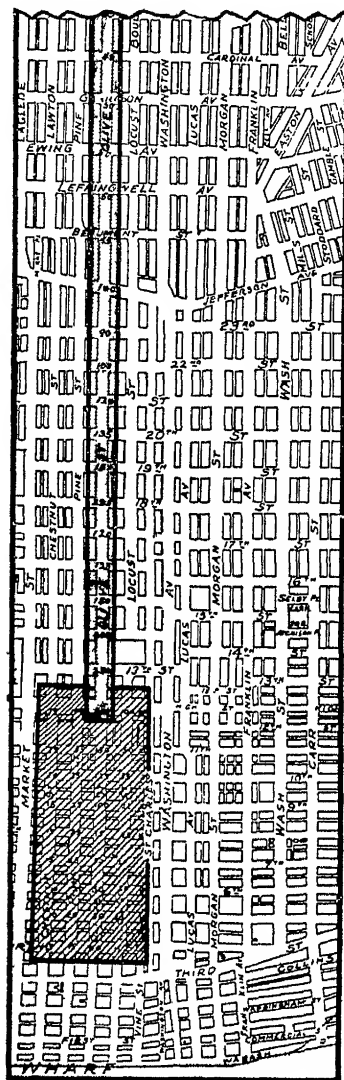
| SAMPLE COPY SCHEDULE C To be made out in duplicate and attached to and made a part of Tax Return | FORM GA-4 STATE OF NEW JERSEY | Month of _____ Year _____ | | | | |
|--|---|---|--------------|------------------|----------------|----------------|
| Name _____ Address _____ | | | | | | |
| LINE 11—Form GA 1—Sales and transfers outside N J | | | | | | |
| | | GALLONS <table border="1" style="width: 100%; border-collapse: collapse;"> <tr> <th style="width: 50%;">N J TAX PAID</th> <th style="width: 50%;">N J TAX NOT PAID</th> </tr> <tr> <td style="text-align: center;">XXXX XXXX XXXX</td> <td style="text-align: center;">XXXX XXXX XXXX</td> </tr> </table> | N J TAX PAID | N J TAX NOT PAID | XXXX XXXX XXXX | XXXX XXXX XXXX |
| N J TAX PAID | N J TAX NOT PAID | | | | | |
| XXXX XXXX XXXX | XXXX XXXX XXXX | | | | | |
| (a) Export to Storage of N J Company in other States (Transfers) (b) Export Sales—Export Report No. _____ to No. _____ (c) Exports to vendors in other States by returns—list individually | Consignor _____ Destination _____ Carrier _____ State From _____ | | | | | |

| | | |
|--|---|---|
| SAMPLE COPY SCHEDULE D To be made out in duplicate and attached to and made a part of Tax Return | NEW FORM GA-5 STATE OF NEW JERSEY | Month of _____ Year _____ |
| Name _____ Address _____ | | |
| LINE 11A—Form GA-1—Sales for Export out of N J | | |
| | | GALLONS N J TAX NOT PAID |
| (a) Sales for Export—Export Report No. _____ to No. _____ | Consignor _____ Destination _____ Carrier _____ State From _____ | |

[illegible]

Appendix H—Special Assessment Zone Map

Olive Street Widening, St. Louis, Mo.



Appendix I—Subscription Forms

Federal Debt Issue Subscription Forms

EA-RFCN

For use when Reconstruction Finance Corporation 7/8 percent notes of Series P maturing November 1, 1941 are tendered for payment

FEDERAL RESERVE BANK OF NEW YORK
Fiscal Agent of the United States

SUBSCRIPTION FOR UNITED STATES OF AMERICA 1 PERCENT TREASURY NOTES OF SERIES A 1946

Dated November 1, 1941

Due March 15, 1946

One day's interest on \$1,000 on coupon payable March 15, 1946 (154 days in 181 day period) is \$2 07/32¢.

NOTE:

Subscriptions from holders of Series P notes who tender them for payment under the provisions of Treasury Department Circular No. 671 will be allotted in full.
Coupons dated November 1, 1941 should be detached from Series P notes when surrendered.

FEDERAL RESERVE BANK OF NEW YORK,
Fiscal Agent of the United States,
Government Bond Department,
New York, N. Y.

Dated at _____ 1941

DEAR SIR:

Subject to the provisions of Treasury Department Circular No. 671, dated October 23, 1941, the undersigned hereby subscribes for United States of America 1 percent Treasury Notes of Series A 1946 as stated below:

For own account \$ _____
For our customers (for use of banking institutions) as shown on back of this form \$ _____

Total Subscription \$ _____

and tenders herewith for payment a like face amount of Reconstruction Finance Corporation notes designated Series P, maturing November 1, 1941, the proceeds of which are to be applied in payment of United States of America 1 percent Treasury Notes of Series A 1946 subscribed for and allotted.

Issue United States of America 1 percent Treasury Notes of Series A 1946 allotted on this subscription in the denominations and amounts as indicated below:

Reconstruction Finance Corporation notes of Series P tendered for payment are, as indicated below, —

| Number of Pieces | Denominations | Par Amount | Leave this space blank |
|------------------|---------------|------------|------------------------|
| _____ | \$100 | _____ | _____ |
| _____ | 500 | _____ | _____ |
| _____ | 1,000 | _____ | _____ |
| _____ | 5,000 | _____ | _____ |
| _____ | 10,000 | _____ | _____ |
| _____ | 100,000 | _____ | _____ |
| _____ | Total | _____ | _____ |

Delivered to you herewith \$ _____
To be withdrawn from securities you are holding for our account \$ _____
To be delivered to you for our account by \$ _____

Dispose of the securities allotted on this subscription in the amounts and as indicated below:

1. Deliver over the counter to the undersigned \$ _____
2. Ship to the undersigned \$ _____
3. Hold in safekeeping (for member bank only) \$ _____
4. Hold as collateral for War Loan deposits \$ _____
5. Deliver as indicated below \$ _____

Deliver to:

| Par Amount | Against Payment of |
|------------|--------------------|
| \$ _____ | \$ _____ |
| \$ _____ | \$ _____ |
| \$ _____ | \$ _____ |

and credit proceeds to our Reserve account _____ ☐

or to our account with _____ ☐

The undersigned, if a bank or trust company, hereby certifies: (a) that the securities which you are hereby or hereafter instructed to dispose of in the manner indicated in item numbered 3 above are the sole property of the undersigned; and (b) that the securities which you are hereby or hereafter instructed to dispose of in the manner indicated in item numbered 4 and 5 above are either the sole property of the undersigned or the property of its customers who have authorized in writing such disposition.

(Fill in all required spaces before signing)

TO SUBSCRIBER

Name of Subscriber _____ (Please print)

Please indicate if this is a confirmation. _____

By _____ (Official signature required) (This)

Street address _____

City, Town or Village, and State _____

Spaces below are for the use of the Federal Reserve Bank of New York

| | | |
|------------------------|--------------------|--------------------------|
| Released _____ | Full Receipt _____ | By _____ |
| Taken from Vault _____ | Amount _____ | Received for _____ |
| Counted _____ | _____ | United States of America |
| Checked _____ | _____ | Subscribe _____ |
| Delivered _____ | By _____ | Date _____ |

Federal Debt Issue Subscription Forms (continued)

EA-H-66

EXCHANGE SUBSCRIPTION

For Use When United States of America 1½ Percent Treasury Notes of Series C-1941 Maturing December 15, 1941 Are Tendered in Payment

FOR UNITED STATES OF AMERICA 2½ PERCENT TREASURY BONDS OF 1967-72

Dated October 20, 1941

Due September 15, 1972

NOTE:

Coupons dated December 15, 1941, should be attached to the notes when surrendered and accrued interest from June 15, 1941, to October 20, 1941 (\$4 33743 per \$1,000), will be paid following acceptance of the notes.

If registered securities of the series offered are desired upon issue the required necessary instructions must be given as indicated in the spaces provided on this subscription.

Subscriptions for which securities of the United States are tendered in payment and accepted will be allotted in full.

FEDERAL RESERVE BANK OF NEW YORK,
Fiscal Agent of the United States,
New York, N. Y.

Dated at _____ 1941

DEAR SIR:

Pursuant to the provisions of Treasury Department Circular No. 670, dated October 9, 1941, the undersigned hereby subscribes for United States of America 2½ percent Treasury Bonds of 1967-72, in the amount and as stated below, and tenders in payment therefor United States of America 1½ percent Treasury Notes of Series C-1941, maturing December 15, 1941, which are

Delivered to you herewith

In the amount of \$.. ..

To be delivered to you for our account

by \$

To be withdrawn from securities
you are holding for our account

\$

Total amount of subscription

\$

Pay accrued interest on securities surrendered

- by credit to our Reserve account ☐
by check made payable to our order ☐
by credit to our account with ☐

Issue and dispose of securities allotted on this subscription as indicated below

| Indicate by X mark | | When both coupon securities and registered securities are desired, use a separate subscription form for each. | | DISPOSITION | | | | | | | | | | | |
|--------------------|--------------------|---|--|-------------|--|------------|--------------------|----------|----------|----------|----------|----------|----------|----------|----------|
| In coupon form | In registered form | | | | | | | | | | | | | | |
| DENOMINATIONS | | | | | | | | | | | | | | | |
| Face | Par Value | Leave Blank | | | | | | | | | | | | | |
| \$50 | | | 1 Deliver over the counter to the under signed \$ | | | | | | | | | | | | |
| 100 | | | 2 Ship to the undersigned \$ | | | | | | | | | | | | |
| 500 | | | 3 Hold in safekeeping (For member bank only) \$ | | | | | | | | | | | | |
| 1,000 | | | 4 Register in the names as indicated in the schedule on reverse side <input type="checkbox"/> | | | | | | | | | | | | |
| 5,000 | | | 5 Hold as collateral for War Loan deposits \$ | | | | | | | | | | | | |
| 10,000 | | | 6 Deliver as indicated below \$ | | | | | | | | | | | | |
| XX XXX | | | Deliver to | | | | | | | | | | | | |
| 100,000 | | | <table border="1"> <thead> <tr> <th>Par Amount</th> <th>Against Payment of</th> </tr> </thead> <tbody> <tr> <td>\$</td> <td>\$</td> </tr> <tr> <td>\$</td> <td>\$</td> </tr> <tr> <td>\$</td> <td>\$</td> </tr> <tr> <td>\$</td> <td>\$</td> </tr> </tbody> </table> | | | Par Amount | Against Payment of | \$ | \$ | \$ | \$ | \$ | \$ | \$ | \$ |
| Par Amount | Against Payment of | | | | | | | | | | | | | | |
| \$ | \$ | | | | | | | | | | | | | | |
| \$ | \$ | | | | | | | | | | | | | | |
| \$ | \$ | | | | | | | | | | | | | | |
| \$ | \$ | | | | | | | | | | | | | | |
| Total | | | and credit proceeds to our Reserve account <input type="checkbox"/> or to our account with <input type="checkbox"/> | | | | | | | | | | | | |

The undersigned, if a bank or trust company, hereby certifies (a) that the securities which you are hereby or hereafter instructed to dispose of in the manner indicated in item numbered 3 above are the sole property of the undersigned, and (b) that the securities which you are hereby or hereafter instructed to dispose of in the manner indicated in items numbered 5 and 6 above are either the sole property of the undersigned or the property of its customers who have authorized in writing such disposition.

(Fill in all required spaces before signing)

TO SUBSCRIBER

Please indicate if this is a confirmation

If subscriber is a Bank or Trust Company, please indicate amount of this subscription for own account.

\$

Name of Subscriber (Please print)
By (Official signature required) (Title)
Street address
City, Town or Village, and State

Spaces below for the use of the Federal Reserve Bank

| RECEIVED | CHECKED | TAKEN FROM VAULT | COUNTED | CHECKED | BLOTTER | DELIVERED | AMOUNT |
|----------|---------|------------------|---------|---------|---------|-----------|--------|
| | | | | | | | |

Federal Debt Issue Subscription Forms (concluded)

6A

No. _____

TENDER FOR 91-DAY TREASURY BILLS

Dated October 8, 1941

Maturing January 7, 1942

Dated at _____

To THE FEDERAL RESERVE BANK OF NEW YORK,
Fiscal Agent of the United States,
New York City, N. Y.

1941

Pursuant to the provisions of Treasury Department Circular No. 418, as amended, and to the provisions of the public notice on October 3, 1941, as issued by the Secretary of the Treasury, the undersigned offers to pay _____* (Rate per 100) for a total amount of \$ _____ (maturity value) of the Treasury bills therein described, or for any less amount that may be awarded, payment therefor to be made at your bank in cash or other immediately available funds on the date stated in the public notice.

The Treasury bills for which tender is hereby made are to be dated October 8, 1941, and are to mature on January 7, 1942.

This tender will be inserted in special envelope entitled "Tender for Treasury bills"

IMPORTANT INSTRUCTIONS:

1. No tender for less than \$1,000 will be considered, and each tender must be for an even multiple of \$1,000 (maturity value). Also, if more than one price is offered, a separate tender must be executed at each price.

2. If the person making the tender is a corporation, the tender should be signed by an officer of the corporation authorized to make the tender, and the signing of the tender by an officer of the corporation will be construed as a representation by him that he has been so authorized. If the tender is made by a partnership, it should be signed by a member of the firm, who should sign in the form "_____, a member of the firm," _____ a copartnership, by _____.

3. Tenders will be received without deposit from incorporated banks and trust companies and from responsible and recognized dealers in investment securities. Tenders from others must be accompanied by payment of 10 percent of the face amount of Treasury bills applied for, unless the tenders are accompanied by an express guaranty of payment by an incorporated bank or trust company.

4. If the language of this tender is changed in any respect, which, in the opinion of the Secretary of the Treasury, is material, the tender may be disregarded.

Payment by credit through War Loan Deposit Account will not be permitted.

 Fill in all required spaces before signing.

Name of Subscriber _____ (Please print)

By _____ (Official signature required) _____ (Title)

Street Address _____

City, Town or Village, and State _____

SPACES BELOW ARE FOR THE USE OF THE FEDERAL RESERVE BANK

| Received | Classified | Classified | Ledger | Acknowledged | Disposition | |
|----------|------------|------------|---------|-------------------|-------------|-------------------|
| Amount | Figured | Checked | Advised | Method of Payment | Amount | Date Released |
| Received | Checked | Recorded | Window | Cashier | Mail | Other Departments |

FD-202-4

* Price must be expressed on the basis of 100, with not more than three decimal places, e. g., 99.999. Fractions may not be used.

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